

AGENDA – November 17, 1999 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1525.2, *Manufacturing Equipment*

<p>Action 1 – Claim for Refund</p> <p>Proposal to amend Regulation 1525.2 (f)(3), <i>Exemption Certificates</i></p>	<p>Adopt either: 1) Staff’s recommendation to make no change to the regulation (Exhibit 1, pages 1-3); or 2) Industry 1’s (manufacturers) proposed language (Exhibit 1, pages 1-3)</p>
<p>Action 2 – Consumables</p> <p>1. Proposal to amend Regulation 1525.2 (c)(9)(B), <i>Definitions – “Tangible Personal Property” does not include</i></p> <p>2. Proposal to amend Regulation 1525.2 (c)(10)(B), <i>Definitions – “Tangible Personal Property” includes</i></p>	<p>1. Adopt either: 1) Staff’s and Industry 2’s (retailers) recommendation to make no change to the regulation (Exhibit 1, pages 3-6); or 2) Industry 1’s (manufacturers) proposed language (Exhibit 1, pages 3-6)</p> <p>2. Adopt either: 1) Staff’s and Industry 2’s (retailers) recommendation to make no change to the regulation (Exhibit 1, pages 3-6); or 2) Industry 1’s (manufacturers) proposed language (Exhibit 1, pages 3-6)</p>
<p>Action 3 – Definition of “Establishment”</p> <p>Proposal to amend Regulation 1525.2 (c)(6)(B), <i>Definitions – “Qualified Person”</i></p>	<p>Adopt either: 1) Staff’s recommendation to make no change to the regulation (Exhibit 1, pages 6-11); or 2) Industry 1’s (manufacturers) proposed language (Exhibit 1, pages 6-11)</p>
<p>Action 4 – Authorization to Publish</p> <p>(whichever language is approved)</p>	<p>Direct the publication of the proposed amendments to Regulation 1525.2 as adopted in the above actions.</p> <p>Operative Date: None Implementation: Upon OAL approval</p>

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Action Item	Current Regulatory Language (Proposed by Staff)	Industry 1 (Manufacturers) Proposed Language
ACTION 1 Claim for Refund Exhibit 1, pages 1-3	<p>(f) Exemption Certificates.</p> <p>(3) Waiver of Partial Exemption. Except as specifically set forth in section 6902.2 of the Revenue and Taxation Code:</p> <p style="padding-left: 40px;">(A) Failure to claim the partial exemption by furnishing the retailer with a manufacturer's exemption certificate within 60 days after an otherwise qualified purchase constitutes a waiver of the partial exemption for that purchase and, as a consequence, the partial exemption cannot be claimed on that purchase.</p> <p style="padding-left: 40px;">(B) Failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer's declaration to such a timely filed return, does not constitute a waiver of the use tax partial exemption for that purchase. A person who fails to file a timely return or attach a completed manufacturer's declaration to a timely return for an otherwise qualified purchase has the burden of establishing that he or she was entitled to claim the partial exemption.</p> <p>For the period commencing on January 1, 1994, and ending on December 31, 1994, a qualified person may claim the partial exemption on qualified purchases from an in-state retailer or an out-of-state retailer obligated to collect the use tax by furnishing the retailer with a manufacturer's exemption certificate on or before March 31, 1995. The retailer must refund the tax directly to the purchaser or, at the purchaser's sole option, the purchaser may be credited with such amount. In the event that the retailer has already reported and paid the tax to the Board, the retailer must file a written claim for refund on or before April 30, 1995.</p> <p style="padding-left: 40px;">(C) A person who self-reported and paid use tax on a qualified purchase from a retailer not engaged in business in this state, and who failed to claim the partial use tax exemption as provided by this</p>	<p>(f) Exemption Certificates.</p> <p>(3) Waiver Refund of Partial Exemption. Except as specifically set forth in section 6902.2 of the Revenue and Taxation Code:</p> <p style="padding-left: 40px;">—(A) Failure to claim the partial exemption by furnishing the retailer with a manufacturer's exemption certificate within 60 days after an otherwise qualified purchase constitutes a waiver of the partial exemption for that purchase and, as a consequence, the partial exemption cannot be claimed on that purchase.</p> <p style="padding-left: 40px;">—(B) Failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer's declaration to such a timely filed return, does not constitute a waiver of the use tax partial exemption for that purchase. A person who fails to file a timely return or attach a completed manufacturer's declaration to a timely return for an otherwise qualified purchase has the burden of establishing that he or she was entitled to claim the partial exemption.</p> <p>For the period commencing on January 1, 1994, and ending on December 31, 1994, a qualified person may claim the partial exemption on qualified purchases from an in-state retailer or an out-of-state retailer obligated to collect the use tax by furnishing the retailer with a manufacturer's exemption certificate on or before March 31, 1995. The retailer must refund the tax directly to the purchaser or, at the purchaser's sole option, the purchaser may be credited with such amount. In the event that the retailer has already reported and paid the tax to the Board, the retailer must file a written claim for refund on or before April 30, 1995.</p> <p style="padding-left: 40px;">(CB) A person who self reported and paid <u>sales or use</u> tax on a qualified purchase from a retailer not engaged in business in this state, and who failed to claim the partial use tax exemption as</p>

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Action Item	Current Regulatory Language (Proposed by Staff)	Industry 1 (Manufacturers) Proposed Language
	regulation may file a claim for refund equal to the amount of the partial exemption that he or she could have claimed pursuant to this regulation. The procedure for such a claim shall be the same as for other claims for refund filed pursuant to Revenue and Taxation Code section 6901. A person filing a claim for refund of the partial use tax exemption has the burden of establishing that he or she was entitled to claim the partial exemption with respect to the amount of refund claimed under this part.	provided by this regulation may file a claim for refund equal to the amount of the partial exemption that he or she could have claimed pursuant to this regulation. The procedure for such a claim shall be the same as for other claims for refund filed pursuant to Revenue and Taxation Code section 6901. A person filing a claim for refund of the partial use tax exemption has the burden of establishing that he or she was entitled to claim the partial exemption with respect to the amount of refund claimed under this part.

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Action Item	Current Regulatory Language (Proposed by Staff)	Industry 1 (Manufacturers) Proposed Language
ACTION 2 Consumables Exhibit 1, pages 3-6	<p>(c) Definitions.</p> <p>(9) "Tangible personal property" does not include any of the following:</p> <p>(B) Consumables with a normal useful life of less than one year, except as provided in subsection (c)(10)(E). Tangible personal property that the qualified person treats as having a normal useful life of less than one year for state income or franchise tax purposes or tangible personal property which is acquired by the qualified person at a unit cost of \$250 or less is tangible personal property with a normal useful life of less than one year for purposes of this regulation.</p> <p>(10) "Tangible personal property" includes but is not limited to the following:</p> <p>(B) All equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, without limitation, computers, data processing equipment, and computer software, including both operating programs and application programs, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the taxpayer or another party. Any repair and replacement parts that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall have a useful life of less than one year for purposes of this regulation.</p>	<p>(c) Definitions.</p> <p>(9) "Tangible personal property" does not include any of the following:</p> <p>(B) Consumables with a normal useful life of less than one year, except as provided in subsection (c)(10)(E). <u>For purposes of this regulation, it shall be presumed</u> tTangible personal property that the qualified person treats as having a normal useful life of less than one year for state income or franchise tax purposes or tangible personal property which is acquired by the qualified person at a unit cost of \$250 or less is tangible personal property with a normal useful life of less than one year for purposes of this regulation. <u>This presumption may be rebutted by evidence satisfactory to the board.</u></p> <p>(10) "Tangible personal property" includes but is not limited to the following:</p> <p>(B) All equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, without limitation, computers, data processing equipment, and computer software, including both operating programs and application programs, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the taxpayer or another party. Any repair and replacement parts that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall <u>be presumed to</u> have a useful life of less than one year for purposes of this regulation. <u>This presumption may be rebutted by evidence satisfactory to the board.</u></p>

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Action Item	Current Regulatory Language (Proposed by Staff)	Industry 1 (Manufacturers) Proposed Language
ACTION 3 Definition of “Establishment” Exhibit 1, pages 6-11	<p>(c) Definitions.</p> <p>(6) "Qualified person" means any person that satisfies the requirements of both subsections (c)(6)(A) and (c)(6)(B) below with regard to the trade or business in which the property will be placed into service in the use qualifying the property for this partial exemption:</p> <p>(B) A qualified person must be engaged in those manufacturing lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition. For purposes of this subsection:</p> <p>1. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon value of production. The term "establishment" means an economic unit, generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. The following will generally constitute an "establishment": a factory, mill, store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office.</p> <p>2. For purposes of determining the "establishment" or "establishments" of a trade or business:</p> <p>a. Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such</p>	<p>(c) Definitions.</p> <p>(6) "Qualified person" means any person that satisfies the requirements of both subsections (c)(6)(A) and (c)(6)(B) below with regard to the trade or business in which the property will be placed into service in the use qualifying the property for this partial exemption:</p> <p>(B) A qualified person must be engaged in those manufacturing lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition. For purposes of this subsection:</p> <p>1. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon value of production. The term "establishment" means an economic unit, generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. The following will generally constitute an "establishment": a factory, mill, store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office.</p> <p>2. For purposes of determining the "establishment" or "establishments" of a trade or business:</p> <p>a. Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such</p>

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	<p>economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be "significant" for purposes of this paragraph whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the taxpayer's total dollar value of payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status.</p> <p>b. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments.</p> <p>c. Where a person conducts business at more than one establishment within the meaning of this subsection, then that person shall be considered to be a "qualified person" for purposes of this regulation only as to those purchases that are intended to be used and are actually used in those lines of business that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</p>	<p>economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be "significant" for purposes of this paragraph whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the taxpayer's total dollar value of payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status.</p> <p>b. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments.</p> <p>c. Where a person conducts business at more than one establishment within the meaning of this subsection, then that person shall be considered to be a "qualified person" for purposes of this regulation only as to those purchases that are intended to be used and are actually used in those lines of business that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</p> <p><u>1 For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's primary activity based upon gross revenues.</u></p> <p><u>2 "Establishment" is defined as the smallest operating unit for which records provide information on the revenues and cost of operations incurred in those lines of business activities that are</u></p>

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		<p><u>described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</u></p> <p style="padding-left: 40px;"><u>a The services may be provided to other divisions within the same entity or to related parties with or without direct compensation.</u></p> <p style="padding-left: 40px;"><u>b Establishments may include, but are not limited to, departments, divisions, subdivisions and product lines.</u></p>
ACTION 4 Authorization to Publish (whichever language is approved)		

Issue Paper Number 099-056



- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Technology & Administration Committee
- ☐ Other

PROPOSED AMENDMENTS TO REGULATION 1525.2, MANUFACTURING EQUIPMENT

I. Issue

Should Regulation 1525.2, *Manufacturing Equipment*, be amended to: 1) allow claims for refund of the amount of the partial exemption where the partial exemption was not originally claimed in a timely manner and is in lieu of the statutorily authorized refund provisions of Revenue and Taxation Code 6902.2; 2) eliminate the \$250 threshold defining consumable property and provide an option to refute the provisions classifying certain items as consumables that do not qualify for the partial tax exemption; and 3) revise the definition of “establishment” to be based on the definition found in Regulation 1532, *Teleproduction and Other Postproduction Service Equipment* (hereafter, *Teleproduction*)?

II. Staff Recommendation

Staff recommends the Board continue to support the provisions of Regulation 1525.2 as currently written. The subjects of proposed amendments to Regulation 1525.2 - to incorporate provisions for all manufacturers to file a claim for refund, eliminate the threshold test and provide a rebuttable presumption regarding consumables, and the revised definition of establishment - were all addressed in detail during the regulatory process adopting Regulation 1525.2. In staff’s opinion, industry has not demonstrated the existence of new circumstances that would justify adopting the proposed amendments.

III. Other Alternative(s) Considered

As proposed by Industry 1 (Manufacturers), amend Regulation 1525.2, *Manufacturing Equipment*, to:

1. Allow claims for refund of the amount of the partial exemption where the partial exemption was not originally claimed in a timely manner and is in lieu of the statutorily authorized refund provisions of Revenue and Taxation Code 6902.2;
2. Eliminate the \$250 threshold and provide an option to refute the provisions classifying certain items as consumables that do not qualify for the partial tax exemption; and
3. Revise the definition of “establishment” to be identical to the definition found in Regulation 1532, *Teleproduction*.

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IV. Background

Proposal - Claim for Refund

In a letter of August 2, 1999, Mr. Marty Glick of Advanced Medicine, Inc. (Advanced Medicine) provides suggested language to amend section (f) (3) of Regulation 1525.2, *Manufacturing Equipment*. The amendments Advanced Medicine proposes would expand the current provisions for filing a claim for refund to all persons who establish their eligibility for the manufacturer's exemption. The proposed language also stipulates that no interest would be paid on such refunds.

By letter dated July 26, 1999, Ms. Linda Balabanian of KPMG LLP (KPMG) proposes deleting subdivision (f)(3)(A) of Regulation 1525.2. KPMG states that the proposed change is intended to allow any qualified purchaser who did not timely pre-qualify for the manufacturer's exemption to obtain, through the retailer in the case of sales tax or directly from the State Board of Equalization (SBE) in the case of use tax, a refund equal to the amount of the partial exemption to which the purchaser would have been entitled, subject to the statute of limitations.

In a September 20, 1999 letter, Mr. Glenn Bystrom of Ernst and Young LLP (Ernst & Young) states, "The current regulation offers a benefit to acquiring property from out-of-state retailers in that sales tax paid to a California retailer is not eligible for refund as is use tax mistakenly paid to the state by the buyer. The endorsement of the suggested amendment would place California retailers on the same footing as out-of-state sellers not engaged in business in California."

Regulatory language proposed by industry is included in **Exhibit 1**.

Proposal - Consumables

In a facsimile dated July 21, 1999, Ernst & Young proposes language to allow a qualified purchaser the option to refute the classification of certain items as consumable items that do not qualify for the partial exemption from tax. In their September 20, 1999 letter they state,

"While we agree [the current] rules do provide a bright line test, our suggested language recognizes that situations occur where items with a useful life of more than one year are expensed for financial and tax reporting purposes. It is not practical to account for all property acquired as an asset even if the useful life may exceed one year. For this reason our proposal retains the general rule regarding the income tax treatment of the property, yet we believe it is appropriate to allow taxpayers the opportunity to rebut this presumption by submitting evidence to establish a useful life of more than one year. We also suggest that the \$250 threshold be removed from the regulation. The amount is arbitrary and without any statutory support. As with other monetary thresholds, the problem of ongoing adjustments to account for inflation occurs."

On October 29, 1999, Mr. Eric Miethke of Nielsen, Merksamer, Parrinello, Mueller, representing PriceCostco (PriceCostco), conveyed PriceCostco's opposition to Ernst & Young's proposal to eliminate the \$250 threshold. Their opinion is that this bright line de minimus test is fair, and helps prevent retailers from having to deal with a high volume of manufacturer's exemption certificates. Alternately,

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if the \$250 threshold is eliminated, PriceCostco proposes that retailers be held harmless from their acceptance of the certificates, without having to demonstrate that the certificates were accepted in good faith.

Regulatory language proposed by Ernst & Young is included in **Exhibit 1**, referenced as “Industry 1 (Manufacturers),” and PriceCostco’s position is represented in **Exhibit 1** as “Industry 2, (Retailers).”

Proposal - Definition of Establishment

At the interested parties meeting on September 9, 1999 and in their September 20, 1999 letter, Ernst & Young suggested that the definition of an “establishment” in Regulation 1525.2 should be based on the definition of an “establishment” as found in Regulation 1532:

1532 (c)(2)(C) “Establishment” is defined as the smallest operating unit for which records provide information on the revenues and cost of operations incurred to perform the teleproduction or postproduction services.

1. The services may be provided to other divisions within the same entity or to related parties with or without direct compensation.
2. Establishments may include, but are not limited to, departments, divisions, subdivisions and product lines.

Regulatory language proposed by industry is included in **Exhibit 1**.

Background and History of Regulation 1525.2

Section 6377 of the Revenue and Taxation Code was added by Statutes of 1993, Chapter 881, in effect October 6, 1993, but operative January 1, 1994, and was later amended by Statutes of 1994, 1995, and 1996. Section 6377 provides an exemption from the state portion of the sales and use tax on purchases by “qualified persons” of tangible personal property for use:

1. In manufacturing, processing, refining, fabricating, or recycling;
2. In research and development activities described in Section 174 of the Internal Revenue Code;
3. To maintain, repair, measure, or test any property described in 1 or 2 above; or
4. By a construction contractor purchasing the property either as an agent of a qualified person or for the contractor’s own account and subsequent resale to a qualified person for use in the performance of a construction contract for the qualified person who will use the tangible personal property as an integral part of the manufacturing, processing, refining, fabricating, or recycling process, or as a research or storage facility for use in connection with the manufacturing process.

Throughout 1994, the partial exemption was equal to six percent. Effective January 1, 1995, the exemption was reduced to five percent. Accordingly, any sale after that date that qualifies for the partial exemption remains subject to all additional taxes imposed above five percent (at least 2 ¼ percent tax, plus any transaction tax imposed in the relevant district).

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The exemption is not automatic since a qualified person may alternatively claim a manufacturer's investment credit (MIC) of six percent of the purchase price on their state income tax return for such purchases of tangible personal property. The sales and use tax exemption is intended to provide an immediate benefit to start-up businesses that would normally not be able to use an income tax credit.

As early as December 1993, an issue paper was drafted that outlined:

- The complexity of the law from an administrative perspective;
- The burden on retailers in
 - 1) accepting exemption certificates from qualified purchasers,
 - 2) identifying non-qualifying property,
 - 3) collecting and reporting taxes based on a partial tax rate, and
 - 4) providing copies of exemption certificates to the Board;
- The fact that new manufacturers may not initially require a seller's permit;
- The responsibility of purchasers to self-report purchases made from retailers not engaged in business in this state;
- The inconsistencies of the law between the sales and use tax exemption and the manufacturer's investment credit (MIC); and
- The proposed prequalification procedures to relieve the retailer's burden.

Regulation 1525.2 was originally drafted and presented to the Board with a request for publication in February 1994. The public hearing was held on August 4, 1994; however, the public comments presented and subsequent enactment of Senate Bill 676, Chapter 751, Statutes of 1994, required re-publication of the proposed regulation. A second public hearing was held on December 6, 1994. In response to public comment, the Board ordered further changes to the proposed regulation, which was returned to the rulemaking file to allow additional comments. On January 10, 1995, the Business Taxes Committee addressed the fifteen-day comments received on the proposed regulation and on January 12, 1995, the Board incorporated changes to the regulation. The proposed regulation was returned to the rulemaking file for a second time to receive additional comments for a fifteen-day period. On February 9, 1995, the Board addressed all public comments and adopted Regulation 1525.2, *Manufacturing Equipment*. The regulation became effective August 18, 1995.

Although the initial regulation was not effective until almost two years after the legislation was in effect, staff prequalified new manufacturers administratively as of January 1, 1994.

The most recent amendment to Regulation 1525.2 was incorporated as a result of an industry association's comments. Subdivision (f) of Regulation 1525.2 provides that to claim the partial exemption, a person must be both pre-qualified by the Board and either registered to hold a seller's permit or maintain a consumer use tax account. Subdivision (f)(3)(B) was amended to provide that failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer's declaration to a timely return, does not constitute a waiver of the use tax partial exemption for that purchase. The burden of establishing that they were entitled to claim the partial exemption is upon the person who fails to file a timely return or attach a completed manufacturer's declaration to a timely return for an otherwise qualified purchase.

Concurrently, subdivision (f)(3)(C) was added to the regulation. This section allows a person who self-reported and paid use tax on a qualified purchase from a retailer not engaged in business in this state, but who failed to claim the partial use tax exemption, to file a claim for refund equal to the amount of the

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partial exemption. Adopted by the Board on December 9, 1998, the regulation as amended became effective April 3, 1999.

Attached are copies of Sales and Use Tax Regulation 1525.2, *Manufacturing Equipment (Exhibit 2)*, California Income Tax Regulation 23649-1, *The Manufacturers' Investment Credit (Exhibit 3)*, and California Income Tax Regulation 23649-3, *Qualified Taxpayer (Exhibit 4)*.

Discussion - Claim for Refund

A meeting with interested parties was held on September 9, 1999 to discuss the proposed amendments. At the meeting, Mr. David Nagler, representing Advanced Medicine, opened the discussion by explaining that Advanced Medicine, Inc. had made purchases from in-state vendors that would have been eligible for the partial exemption, but the company failed to timely file the required paperwork. If these purchases had been made from an out-of-state vendor, the company would have been able to file a claim for refund under the most recently amended provisions of Regulation 1525.2. Their goal in proposing the amendment, Mr. Nagler explained, is to bring uniformity to public policy regarding the manufacturer's exemption and purchases made from in-state versus out-of-state retailers.

The parties discussed the prior amendment to the regulation that addresses purchases made from retailers not engaged in business in this state wherein the retailer is not responsible for the tax on such purchases. On these transactions, the purchaser is allowed to file a claim for refund if they fail to timely claim the exemption on their return or fail to attach a copy of the required certificate. Staff explained that in the situation of purchases made from in-state retailers and out-of-state retailers with nexus, the retailer has the responsibility for the tax and the regulation provides that the purchaser must file an exemption certificate timely. "Timely" is defined by the regulatory provision stating the exemption certificate must be provided to the retailer no later than 60 days after the date of purchase. An industry representative pointed out that the statute does not specifically require the exemption certificate to be filed timely. Likewise, the prequalification process outlined in the regulation is not a statutory requirement. Section 6377 of the Revenue and Taxation Code, however, gives the Board the authority to determine the guidelines by which the purchaser will provide the exemption certificate to the retailer. Staff explained that the "timely" requirement imposed in Regulation 1525.2 was intended to provide consistency with the "timely" requirements of Regulation 1667, *Exemption Certificates*, and Regulation 1668, *Resale Certificates*.

The group also discussed the appropriateness of permitting claims for refund of the manufacturer's exemption in light of Revenue and Taxation Code section 6902.2. Section 6902.2 authorizes taxpayers to file for a refund in lieu of taking the MIC in an amount that would otherwise be allowed pursuant to the MIC. Staff pointed out that the enactment of section 6902.2 demonstrates the extent of the Legislature's intent in permitting refunds to persons engaged in manufacturing activities, as it relates to the partial exemption and MIC. Section 6902.2 does not authorize refunds of the manufacturer's exemption; it authorizes a refund only of the MIC. The MIC is generally available to manufacturers who are not a new trade or business, or to new manufacturers who either elect the MIC in lieu of the partial exemption or who do not timely claim the partial exemption. In staff's view, allowing refunds of the manufacturer's partial exemption to persons who did not timely file an exemption certificate appears to be contrary to the provisions of section 6902.2 and the Legislature's intent. In a letter of October 22, 1999, KPMG disagreed with this view, stating:

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“It is much more likely, since Section 6902.2 is solely in relation to refunds of the MIC, that the legislature wished to avoid a glut of amended income/franchise returns at the Franchise Tax Board. . . .

“The legislature had no reason to believe that the Board would not allow refunds of sales and use tax erroneously paid on exempt transactions and had no reason to add an additional statute to address how claims for refund of the manufacturer’s partial exemption were to be handled. The Revenue and Taxation Code already contains refund provisions, such as Section 6901 to address the handling of refunds of such overpayments of sales and use tax. The refunds addressed in Section 6902.2 are refunds of an income/franchise tax, not sales and use tax. The provisions of Section 6902.2 should not be considered in relation to the proposed amendment to Regulation 1525.2.”

Staff believes, however, that it is just as likely that the Legislature did not intend a refund of the manufacturer’s exemption since none was enacted. The manufacturer’s exemption and MIC are complementary tax incentive programs. With respect to these complementary programs, the Legislature considered what refunds should be allowed to manufacturing entities by virtue of its enactment of Section 6902.2. The Legislature’s enactment of a refund provision for the MIC and not for the manufacturer’s exemption indicates a legislative intent not to allow such refunds.

The group further discussed the appropriateness of allowing a claim for refund when the presumed intent of the legislation was to provide a cash flow benefit to new businesses. Staff pointed out that allowing an after-the-fact claim for refund does not seem to provide the immediate cash flow benefit intended by the legislation. Industry asserted that start-up businesses raise cash on a two to three year cycle to close the gap between revenue and expenditures. And, because of this, new businesses would accrue the intended benefit of the legislation through the refund procedure. Staff believes, however, that the provision of an after-the-fact refund of the manufacturer’s exemption alters the state’s participation in fostering new business from that of a passive participant into that of an active investor required to provide interest on refunds after the immediate value of the cash flow benefit is lost.

The potential for abuse by allowing claims for both the MIC and the partial exemption provided under the sales and use tax statutes was briefly discussed. Industry stated that “double dipping” (claiming both the MIC and the partial sales tax exemption) is possible under the current regulation, if the taxpayer is so inclined. Staff voiced concerns that allowing a claim for refund to be filed on sales tax transactions may increase both the probability for abuse of the benefit and the difficulty in tracking the purchases made by manufacturers. In particular, under current regulatory provisions, a refund of the manufacturer’s partial exemption would be regarded as a general refund. A tracking mechanism is not in place to provide the FTB with information to prevent the taxpayer from also claiming the MIC. Moreover, the FTB does not provide this agency with a list of persons who claim the MIC (nor a list of the property on which the MIC is claimed) to prevent a refund of the partial exemption on the same property. In a letter dated October 22, 1999, KPMG contended that it is the responsibility of the Board and the Franchise Tax Board to arrive at a viable method to cross-reference taxpayers to which a manufacturer’s exemption certificate has been issued, and suggested that the manufacturer could be required to provide copies of its state income/franchise tax return to verify that the MIC has not been claimed on the same property when a refund is claimed. Staff notes, however, that a state income/franchise tax return is insufficient to show which specific property is subject to the MIC. A state income/franchise tax return only shows a cumulative, lump sum MIC claimed by a taxpayer. Indeed, it is unlikely that the Franchise Tax Board

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would find it feasible to make the drastic revisions to income/franchise tax return forms that would be required to capture the level of detail needed to audit for potential “double dipping” on the same purchase. This would require cross-checking all or most information found on a purchase invoice.

The proposed language submitted by Advanced Medicine provides that no interest will be granted on claims for refund filed for the partial exemption from sales tax. Section 6902.2 allows a manufacturer who has paid sales tax reimbursement to a retailer to claim a refund equal to the amount of the MIC which the manufacturer would have otherwise been entitled to claim. Interest is not paid upon 6902.2 refunds by the terms of the statute. The claims for refund permitted in the circumstance where the property is purchased from persons outside California, who are not required to collect California use tax, are filed pursuant to section 6901. These refunds include any applicable interest due on the amount of the refund. At the time of the interested parties’ meeting, a consensus was not reached among industry representatives on whether interest should be allowed on the proposed refund of the partial exemption for purchases made from retailers engaged in business in this state. One of the industry representatives, KPMG, in their September 20, 1999 letter, voiced opposition to language prohibiting credit interest on claims for refund of the manufacturer’s partial exemption. They pointed out that a taxpayer would prefer to receive a refund under the more favorable guidelines of Section 6902.2 (higher rate – 6% vs 5% - and taxable base – generally applicable to the cost of capitalized labor associated with qualifying property), even without credit interest. “However, the new manufacturers that Section 6377 was originally intended to benefit rarely operate in a taxable position for income tax purposes and therefore are usually unable to take advantage of the superior MIC provisions.”

Staff and industry agreed that if industry’s proposal regarding refunds were adopted, any refunds of partial *sales* tax reimbursement should be made by the retailer filing the claim for refund, and not the purchaser.

Discussion - Consumables

Ernst & Young introduced this proposal. They stated that there should be a rebuttable presumption to the provisions that classify an item as a consumable item that does not qualify for the partial tax exemption. Further, they proposed eliminating the regulatory \$250 threshold on the basis that it is an artificial “bright line.” Pursuant to the provisions of the regulation, all items at or below the dollar amount of \$250 are considered consumable items. Thus, the partial exemption cannot be claimed on such items. Staff pointed out that the \$250 threshold was placed in the regulation as a result of concerns voiced by PriceCostco during the regulatory process. PriceCostco was concerned about having to identify at the point of sale whether small dollar value items qualified for the partial tax exemption. PriceCostco has confirmed that their position on this issue has not changed. Their opinion is that this bright line de minimus test is fair, and helps prevent retailers from having to deal with a high volume of manufacturer’s exemption certificates. If the \$250 threshold is eliminated, however, PriceCostco proposes that retailers be held harmless from their acceptance of the certificates, without having to demonstrate that the certificates were accepted in good faith.

Discussion - Definition of Establishment

Ernst & Young additionally entered for discussion a proposal to change the definition of the term “establishment” in Regulation 1525.2 to the definition used in Regulation 1532, *Teleproduction*. They stated that the definition of “establishment” found in Regulation 1532 is the most current definition and

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is easier to comply with. Staff noted that the current definition of “establishment” found in Regulation 1525.2 is taken directly from the standard industrial code (SIC) manual and is also used by the Franchise Tax Board (FTB) for purposes of administering the MIC. There was extensive discussion that changing the definition for sales and use tax purposes may have an unintended impact. In staff’s view, at a minimum, changing the definition would create two different standards for administering the manufacturer’s exemption and the MIC. In their September 20, 1999 letter, Ernst & Young disagreed, arguing that while FTB’s definition is based on the same language, it is not identical to BOE’s (see **Exhibit 4** – Regulation 23649-3 (b)(1)). Furthermore, Regulation 23649-1 (**Exhibit 3**) provides that FTB’s regulation shall have no effect on the sales and use tax law or regulations. Ernst & Young’s understanding is that the reverse is also applicable, that is, Sales Tax Regulations have no effect on FTB’s regulations. Therefore, there is no need to ensure consistency for definitions found in sales and use tax regulations and income tax regulations. Staff continues to believe, however, that the “establishment” definition found in the SIC manual is the appropriate definition since taxpayers may only qualify for the manufacturer’s exemption (and MIC) based on the manufacturing definitions found in the SIC manual itself.

Discussion – Operative Date

Industry stated that because no statutory change would be required, the proposed revisions should not have an operative date. Staff agreed.

Analysis Based on Public Comments During Regulation Adoption

Staff’s position on all the proposals for amendment to Regulation 1525.2 is based on an analysis of the discussions held during the public comment period for the adoption of the regulation. As evidenced by the lengthy period needed to adopt the initial regulation, the public comment period was extensive and included representatives from the Legislature, industry, large and small manufacturing concerns, vendors, and other interested parties. The discussion and subsequent consideration by the Board was in-depth.

At the heart of the discussion was an intrinsically complex sales and use tax statute, coupled with an equally complex income tax statute. The primary desire by all parties was to adopt a regulation and administrative program that would be as simple and straightforward as possible given the many unique qualities inherent in the statute. To this end, a concerted effort was undertaken by legislative staff, BOE and FTB staff, and industry representatives to craft a regulation consistent with the legislative intent of the statute, that would ease the burden on the state’s retailers, and minimize the administrative cost of overseeing the new program.

The manufacturer’s exemption is not directly comparable to other exemptions. This exemption is only available to a select group for a defined period of time. It is a mutually exclusive election to either claim the partial sales and use tax exemption or to claim the MIC. This places an onerous burden upon the state’s retailers as well as the manufacturers. There are three immediate areas that must be addressed before the retailer can in good faith not tax the transaction or the manufacturer can properly claim the partial tax exemption. They must:

1. Determine if the manufacturer is a “qualified person,”
2. Determine if the property being purchased meets the requirements of the statute, and
3. Determine if the exemption is within the three-year period allowed by the statute.

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The exemption is also a *partial* exemption, which further places the retailers at risk if the incorrect rate was exempted from tax. Additionally, the statute clearly contemplated that BOE staff would provide information to the Franchise Tax Board on an ongoing basis to enable them to administer the MIC. The timing difference in claiming the MIC and the partial sales and use tax exemption complicated matters administratively.

Claim for Refund

In drafting the regulation, the legislative staff, BOE and FTB staff, and industry representatives strived to minimize the burdens placed upon the state's retailers and the newest group of taxpayers, the new manufacturers, and to carry out the administrative functions cost effectively. The prequalification process and issuance of exemption certificates with expiration dates clearly identifies for the retailer that the holder of the certificate is a "qualified person" entitled to the exemption within the stated period.

During the public hearing phase of adopting the regulation, testimony was given regarding the appropriateness or need to provide an avenue to file a claim for refund should the manufacturer fail to provide the exemption certificate to the retailer as required by the statute. The proposed regulation before the Board included a provision that the manufacturer must provide the exemption certificate to the retailer within 45 days of the purchase. An industry representative suggested to the Board that the time period for providing the retailer with the exemption certificate should not be a fatal cliff with no turning back. He further proposed allowing a claim for refund in certain defined circumstances - an exception for just cause. Staff opined that ordinarily documents are required to be issued within the normal billing and payment cycle and, in the instance of a deduction for sales for resale, under the statute of limitations these transactions can be established up to three years later. However, for the manufacturer's partial exemption, there is a timing element and a mutually exclusive election that must also be considered. Allowing a claim for refund shifts the burden from to the retailer to file the claim for refund on behalf of the manufacturer, provides for tax planning after the fact, and would increase administrative cost in overseeing the program.

The Board discussed the possibility of allowing a claim for refund. Their discussion took into consideration the potential for increased appeal cases, the burden upon the retailer, the delays which may be encountered in processing amended returns, the potential for audit disputes, and the intent of the legislation. To ensure finality to the election and to relieve the retailer of the liability for the tax on the transaction, the Board increased the time period to 60 days for the exemption certificate to be provided to the retailer, but declined to provide a provision for filing a claim for refund, other than that noted in Section 6902.2. The option to claim the MIC remained open to the manufacturer when an exemption certificate was not timely provided to the retailer.

Subsequent to the adoption of Regulation 1525.2, the Board amended the regulation to permit a refund in circumstances where the property in question is purchased from persons outside California who are not required to collect California use tax from the purchaser. In these circumstances the tax subject to refund is the use tax imposed directly on the purchaser, and the seller did not need to take an exemption certificate to avoid having to pay the tax. The sole party at risk for these transactions is the purchaser, who must take a positive action to self-report the transaction *and* to claim the partial exemption. Non-compliance is high in the area of reporting purchases subject to use tax and it is considered probable that the purchaser/manufacturer would fail to report or incorrectly report the purchase subject to tax. The

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benefit of allowing a claim for refund in these limited circumstances outweighs the costs. Revenue which otherwise may go undetected will be reported, the burden is solely upon the manufacturer to provide the required documentation, and the administrative burdens are less cumbersome.

The proposed language to expand the claim for refund provisions of the regulation states that no interest would be provided on such refunds. The claims for refund allowed in subdivision (f)(3)(C) of Regulation 1525.2 for those purchases made from a retailer not engaged in business in this state are filed pursuant to Revenue and Taxation Code section 6901. Upon approval, such refunds include any applicable interest due on the amount of refund. If the provisions of the regulation are expanded to allow purchases made from retailers engaged in business in this state to be filed pursuant to section 6901, staff agrees that under this statute interest would be applicable.

However, interest is not paid upon section 6902.2 refunds by the terms of the statute. The purpose of the manufacturer's exemption was to relieve the startup business of the burden of the sales tax, a kind of passive investment by the state. The purpose was not to pay cash interest on refund amounts, turning the state into an active cash investor as to interest amounts.

For these reasons, staff remains supportive of the Board's original decision to decline to provide the option to file a claim for refund for those purchases made from retailers engaged in business in this state.

Consumables

At the direction of the Board, the \$250 bright line threshold was incorporated into the provisions of the regulation to determine if an item is considered a consumable item that does not qualify for the partial exemption from tax. The language adopted by the Board also provided that property which the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes, is tangible personal property with a normal useful life of less than one year for purposes of the regulation.

Comments were received on this issue during the public hearing of the regulation also. Mr. Jeff van Burkleo, representing PriceCostco, articulated the concerns of his firm in discerning the appropriateness of accepting an exemption certificate from their customers for specific hardware and small equipment items. The Board incorporated the \$250 threshold to address these very concerns. PriceCostco's position on this issue has not changed. Their opinion is that this bright line de minimus test is fair, and helps prevent retailers from having to deal with a high volume of manufacturer's exemption certificates. If the \$250 threshold is eliminated, however, PriceCostco proposes that retailers be held harmless from their acceptance of the certificates, without having to demonstrate that the certificates were accepted in good faith.

Staff supports the direction of the Board in adopting the provisions currently found in the regulation. Eliminating the bright line test and creating a rebuttable presumption may be premature at this date. Audits of retailers and manufacturers are just now at the three-year audit mark. Staff suggests revisiting this issue if audit results reflect this as a problem area for either the retailers or manufacturers. To our knowledge, we have encountered no disputes in this area.

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Definition of Establishment

During the drafting stage of Regulation 1525.2, staff from both the FTB and BOE worked together to ensure a consistent approach in implementing the statute for the MIC and the partial sales and use tax exemption. The definition of a qualified person for both agencies is in part based on the SIC manual and for consistency the definition of establishment is also based on the SIC manual. While the definition used by the FTB to administer the MIC differs from the exact wording in Regulation 1525.2, the FTB's definition is clearly based on the SIC manual. Staff contends that changing the definition of establishment in Regulation 1525.2 to that used in Regulation 1532, *Teleproduction* would result in the FTB and BOE using two different standards to implement the same law. The MIC and partial sales and use tax exemption work hand in glove and severing the two does not appear beneficial.

Under the definition of "establishment" in Regulation 1532, an established business can easily create a segregated work group that qualifies for the teleproduction exemption. To obtain the teleproduction exemption, a qualified person need only be in a line of business that is primarily engaged in teleproduction or other postproduction activities as defined. There is no requirement under Regulation 1532 that the business be a new business, and the teleproduction exemption is not an expiring one.

If Regulation 1525.2 adopted the definition of establishment found in Regulation 1532, it would be fairly easy for long established businesses to create a new "establishment" that would qualify for the manufacturing exemption, thereby circumventing the Legislature's intent to attract new manufacturers to the State of California.

V. Staff Recommendation

A. Description of the Staff Recommendation

Staff recommends that the Board continue to support the provisions of Regulation 1525.2 as written. The subjects of the proposed amendments to Regulation 1525.2, to incorporate provisions for all manufacturers to file a claim for refund, eliminate the threshold test and provide a rebuttable presumption regarding consumables, and the definition of establishment, were all addressed in detail during the regulatory process adopting Regulation 1525.2. In staff's opinion, industry has not demonstrated the existence of new circumstances that would justify adopting the proposed amendments.

B. Pros of the Staff Recommendation

- Claim for refund: Avoids increased potential for "double dipping" by businesses claiming both the partial exemption and the MIC; avoids increased verification difficulties for BOE and FTB staff; maintains the integrity of the prequalification process.
- Consumables: Avoids a burden on retailers, who otherwise may be presented with an increased number of exemption certificates for small purchases.
- Definition of establishment: Avoids BOE and FTB using two different standards to implement the same law; avoids the possibility of circumventing the Legislature's intent to attract new manufacturers to the State.
- Requires no statutory or regulatory change.
- Involves no risk of revenue loss to the state.

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C. Cons of the Staff Recommendation

- Claim for refund: Does not bring uniformity to public policy regarding the manufacturer's exemption and purchases made from in-state versus out-of-state retailers.
- Consumables: Does not eliminate the artificial "bright line" created by the regulatory \$250 threshold.
- Definition of establishment: Maintains the current definition in the regulation, which may be difficult to comply with.

D. Statutory or Regulatory Change

No statutory or regulatory change is required.

E. Administrative Impact

There is no additional administrative impact.

F. Fiscal Impact

1. Cost Impact

There are no additional costs related to staff's recommendation.

2. Revenue Impact

There is no revenue impact.

G. Taxpayer/Customer Impact

There is no additional impact on taxpayers/customers.

H. Critical Time Frames

Not applicable.

VI. Alternative 1

A. Description of the Alternative

As proposed by Industry 1 (Manufacturers), amend Regulation 1525.2, *Manufacturing Equipment*, to:

- Allow claims for refund of the amount of the partial exemption where the partial exemption was not originally claimed in a timely manner and is in lieu of the statutorily authorized refund provisions of Revenue and Taxation Code 6902.2;
- Eliminate the \$250 threshold and provide an option to refute the provisions classifying certain items as consumables that do not qualify for the partial tax exemption; and
- Revise the definition of "establishment" to be based on the definition found in Regulation 1532, *Teleproduction*.

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B. Pros of the Alternative

- Claim for refund: Would bring uniformity to public policy regarding the manufacturer's exemption and purchases made from in-state versus out-of-state retailers.
- Consumables: Would eliminate artificial "bright line" created by the regulatory \$250 threshold.
- Definition of establishment: Would use the most current definition approved by the Board for another partial exemption (Regulation 1532, *Teleproduction*), which would be easier to comply with.

C. Cons of the Alternative

- Claim for refund: Would increase potential for "double dipping" by allowing claims for both the partial exemption and the MIC; would increase verification difficulties for BOE and FTB staff; would undermine the prequalification process.
- Consumables: Could place a burden on retailers, who may be presented with an increased number of exemption certificates for small purchases.
- Definition of establishment: Would result in BOE and FTB using two different standards to implement the same law; might circumvent the Legislature's intent to attract new manufacturers to the State.

D. Statutory or Regulatory Change

Would require a regulatory amendment.

E. Administrative Impact

It is expected that the Board's Refunds Section workload and that of FTB staff would increase to an extent that cannot be determined at this time, due to a probable increase in the number of claims for refund received by BOE and an increase in the difficulty of ensuring that refunds are not paid to purchasers who also filed for the MIC on their income tax returns. The workload relating to reviewing exemption certificates would be likely to increase as well, as a result of an expected increase in the number of exemption certificates filed due to the revised definition of "establishment."

Implementation of the proposed amendments is contingent upon the approval of the Office of Administrative Law (OAL). In the interim, staff action on in-process audits, disputed audit decisions, and audit selection would be suspended.

Once OAL approval has been received, implementation would consist of notification to industry and to staff, and staff training. Industry would be notified by a special notice and through a *Tax Information Bulletin* article. Staff would be notified initially by memorandum, followed by an *Operations Memo* and updated staff training.

F. Fiscal Impact

1. Cost Impact

Costs related to processing additional claims for refund would be minimal. Costs for verifying that the MIC was not claimed from FTB on these additional claims could be substantial, and

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would depend on the volume of refund claims presented. Since a revision of the definition for “establishment” would be likely to cause more “establishments” to qualify for the partial exemption, there would be an increase in the number of exemption certificates that must be reviewed by Return Analysis and Audit Evaluation and Planning Section staff. This increased workload is likely to require up to one additional PY for each section.

2. Revenue Impact

The Alternate Proposal would result in a State General Fund revenue impact as follows:

Claims for Refund:

It is estimated that the revenue loss on claims for refunds would be less than \$760,000.

Consumables:

It is estimated that the revenue loss on eliminating the \$250 threshold and providing an option to refute the provisions classifying certain items as consumables would be less than \$500,000.

Definition of Establishment

It is estimated that the revenue loss from the broader definition of “establishment” would be approximately \$3 million.

G. Taxpayer/Customer Impact

Both manufacturers and their vendors would be impacted by the proposed amendments:

- Qualified persons who failed to timely claim the manufacturer’s exemption on qualified purchases from in-state retailers would be entitled to request a refund of the amount of the partial exemption. Retailers would need to file the claims for refund on behalf of their customers.
- Purchasers of equipment costing less than \$250 could claim the partial exemption if the equipment qualified for the manufacturer’s exemption. It is probable that retailers would be presented with an increased number of exemption certificates.
- The proposed revision to the definition of “establishment” could allow long established businesses to create new “establishments” that would qualify for the manufacturing exemption, thereby increasing the number of exemption claims.

H. Critical Time Frames

Because the proposed amendments are based on a reinterpretation of existing statute, there is no operative date. The amendments would be retroactive if approved.

Prepared by: Program Planning Division
Sales and Use Tax Department

Current as of: November 5, 1999

199-056.doc



REGULATION 1525.2 – MANUFACTURING EQUIPMENT

Staff Recommendation

The subjects of proposed amendments to Regulation 1525.2 - to incorporate provisions for all manufacturers to file a claim for refund, eliminate the \$250 threshold test and provide a rebuttable presumption regarding consumables, and the definition of establishment - were all addressed in detail during the regulatory process adopting Regulation 1525.2. In staff's opinion, industry has not demonstrated the existence of new circumstances that would justify adopting the proposed amendments. Consequently, staff recommends the Board continue to support the provisions of Regulation 1525.2 as currently written.

Alternative Proposal

As proposed by industry, amend Regulation 1525.2, *Manufacturing Equipment*, to:

Allow claims for refunds of the amount of the partial exemption where the partial exemption was not originally claimed in a timely manner and is in lieu of the statutorily authorized refund provisions of Revenue and Taxation Code 6902.2

Eliminate the \$250 threshold and provide an option to refute the provisions classifying certain items as consumables that do not qualify for the partial tax exemption.

Revise the definition of "establishment" to be identical to the definition found in Regulation 1532, *Teleproduction*.

Background, Methodology, and Assumptions

Staff Recommendation:

The staff recommendation has no revenue impact.

Alternative Proposal:Claims for Refund:

Under the current provisions of Regulation 1525.2 a new manufacturer must first prequalify with the Board and then issue a manufacturer's exemption certificate to their vendor within 60 days of the purchase of tangible personal property from an in-state retailer or from an out-of-state retailer with nexus to California. If a manufacturer does not timely claim the exemption, it is precluded from claiming the partial exemption from the sales tax. However, the manufacturer may claim a Manufacturer's Investment Credit (MIC) or submit a claim for refund to the Board for the allowable MIC to the extent that its income tax liability is as large as the claimed MIC.

A manufacturer that is precluded from claiming an exemption from the sales tax because it did not timely file for the exemption and who does not have an income tax liability (in the current year) as large as the MIC at issue may carry forward its MIC. The MIC may be carried forward by the taxpayer for a period of up to 10 years. By allowing manufacturers to file a claim for refund for sales tax, some manufacturers that would otherwise not be allowed to immediately claim the MIC will be able to claim it as a refund of the partial exemption even though a timely exemption certificate was not provided to the retailer and despite the fact that the MIC could be claimed at a later date.

The Sales and Use Tax Department tabulates the claimed exemptions from sales and use tax shown on returns. For calendar years 1995 through 1997, amounts claimed for the manufacturer's exemption have averaged \$152.1 million annually, resulting in an average annual State General Fund tax reduction of $.05 \times \$152.1 \text{ million} = \7.6 million . Although there are some instances where manufacturers are precluded from claiming the exemption under current provisions of Regulation 1525.2, a portion of potential recipients of the exemption are affected. It is anticipated that the alternative proposal would increase the claimed exemptions by no more than 10 percent thereby resulting in an additional reduction to the annual State General Fund of approximately \$760,000.

Consumables:

Under the current provisions of Regulation 1525.2, items at or below the dollar amount of \$250 are considered a consumable item. Thus, the partial exemption cannot be claimed on such items. This proposal would eliminate the \$250 threshold from the regulation.

We have no data on this issue. Nevertheless, we believe that the revenue impact of this proposal would be less than \$500,000

Definition of Establishment

The partial sales and use tax exemption for manufacturing equipment applies only to new manufacturers. The Manufacturers' Investment Credit (MIC) is an income tax credit that applies to both new and established manufacturers. The MIC is a 6% credit against income tax liability. The sales tax exemption is an exemption from the 5% state sales and use tax. The MIC is the larger credit and companies will take this credit where they do not qualify for the partial exemption.

New manufacturers have the option to take the MIC or the partial sales and use tax exemption for purchases of manufacturing equipment. Established manufacturers can only take the MIC.

This proposal would define “establishment” “as the smallest operating unit for which records provide information on the revenues and cost of operations incurred in those lines of business activities that are described in codes 2011 to 3999, inclusive of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition. The services may be provided to other divisions within the same entity or to related parties with or without direct compensation. Establishments may include, but are not limited to, departments, divisions, subdivision, and product lines.”

This definition would allow new businesses whose single most predominant activity is not manufacturing to have a portion of their business qualify for the partial exemption where just a department, division, subdivision, or other unit engages in manufacturing activity. Under the current provisions of Regulation 1525.2, a department, division, or subdivision of a non-manufacturing business does not qualify for the partial exemption unless 25 percent or more of that business’s total employees and dollar value of its payroll from a definable operation of that business is attributable to a manufacturing activity.

Under this alternative, significantly more units of businesses not otherwise predominantly engaged in a manufacturing activity would qualify for the partial exemption. We have no way of definitively knowing at this time how many more units of a business would now qualify for the partial exemption. We estimate that this alternative would increase the claimed partial exemptions by 40 percent resulting in an additional reduction to the annual State General Fund of approximately \$3 million. This amount, however, could significantly fluctuate depending on the number of units of new businesses that may qualify pursuant to the proposed broader language of “establishment.”

Revenue Estimate

The Staff Recommendation has no revenue impact.

The Alternate Proposal would result in a State General Fund revenue impact as follows:

Claims for Refund:

It is estimated that the revenue loss on claims for refunds would be less than \$760,000.

Consumables:

It is estimated that the revenue loss on eliminating the \$250 threshold and providing an option to refute the provisions classifying certain items as consumables would be less than \$500,000.

Definition of Establishment

It is estimated that the revenue loss from the broader definition of “establishment” would be approximately \$3 million.

Preparation

This revenue estimate was prepared by David E. Hayes, Statistics Section, Agency Planning and Research Division. This revenue estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division and Ms. Freda Orendt-Evans, Program Planning Manager, Sales and Use Tax Department. For additional information, please contact Mr. Hayes at (916) 445-0840.

Current as of November 4, 1999

Regulation 1525.2, Manufacturing Equipment
Comparison of Current and Proposed Industry Language
Current as of 11/5/99

Action Item	Current Regulatory Language (Staff's Recommendation)	Regulatory Language Proposed by Industry 1 (Manufacturers)	Regulatory Language Proposed by Industry 1 – Modified to Address Concerns of Industry 2 (Retailers)	Summary Comments
Action 1 – Claim for Refund	<p>(f) Exemption Certificates.</p> <p>(3) Waiver of Partial Exemption. Except as specifically set forth in section 6902.2 of the Revenue and Taxation Code:</p> <p>(A) Failure to claim the partial exemption by furnishing the retailer with a manufacturer's exemption certificate within 60 days after an otherwise qualified purchase constitutes a waiver of the partial exemption for that purchase and, as a consequence, the partial exemption cannot be claimed on that purchase.</p> <p>(B) Failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer's declaration to such a timely filed return, does not constitutes a waiver of the use tax partial exemption for that purchase. A person who fails to file a timely return or attach a completed manufacturer's declaration to a timely return for an otherwise qualified purchase</p>	<p>(f) Exemption Certificates.</p> <p>(3) Waiver Refund of Partial Exemption: Except as specifically set forth in section 6902.2 of the Revenue and Taxation Code:</p> <p>—(A) Failure to claim the partial exemption by furnishing the retailer with a manufacturer's exemption certificate within 60 days after an otherwise qualified purchase constitutes a waiver of the partial exemption for that purchase and, as a consequence, the partial exemption cannot be claimed on that purchase.</p> <p>—(B) Failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer's declaration to such a timely filed return, does not constitutes a waiver of the use tax partial exemption for that purchase. A person who fails to file a timely return or attach a completed manufacturer's declaration to a timely return for an otherwise qualified purchase</p>	<p>(f) Exemption Certificates.</p> <p>(3) Waiver Refund of Partial Exemption: Except as specifically set forth in section 6902.2 of the Revenue and Taxation Code:</p> <p>—(A) Failure to claim the partial exemption by furnishing the retailer with a manufacturer's exemption certificate within 60 days after an otherwise qualified purchase constitutes a waiver of the partial exemption for that purchase and, as a consequence, the partial exemption cannot be claimed on that purchase.</p> <p>—(B) Failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer's declaration to such a timely filed return, does not constitutes a waiver of the use tax partial exemption for that purchase. A person who fails to file a timely return or attach a completed manufacturer's declaration to a timely return for an otherwise qualified purchase</p>	<p>Industry 1 proposes to amend subsection (f) to allow claims for refund of the amount of the manufacturer's exemption where the exemption was not originally claimed in a timely manner. Such claims would be in lieu of refund provisions of Revenue and Taxation Code 6902.2 (manufacturer's investment credit). The proposed amendments would erase the distinction currently provided in subsection (f)(3)(C) allowing claims for refund only for transactions in which a person self reported and paid use tax on a qualified purchase from a retailer not engaged in business in this state, and who</p>

Regulation 1525.2, Manufacturing Equipment
Comparison of Current and Proposed Industry Language
Current as of 11/5/99

Action Item	Current Regulatory Language (Staff's Recommendation)	Regulatory Language Proposed by Industry 1 (Manufacturers)	Regulatory Language Proposed by Industry 1 – Modified to Address Concerns of Industry 2 (Retailers)	Summary Comments
	<p>has the burden of establishing that he or she was entitled to claim the partial exemption.</p> <p>For the period commencing on January 1, 1994, and ending on December 31, 1994, a qualified person may claim the partial exemption on qualified purchases from an in-state retailer or an out-of-state retailer obligated to collect the use tax by furnishing the retailer with a manufacturer's exemption certificate on or before March 31, 1995. The retailer must refund the tax directly to the purchaser or, at the purchaser's sole option, the purchaser may be credited with such amount. In the event that the retailer has already reported and paid the tax to the Board, the retailer must file a written claim for refund on or before April 30, 1995.</p> <p>(C) A person who self-reported and paid use tax on a qualified purchase from a retailer not engaged in business in this state, and who failed to claim the partial use tax exemption as provided by this regulation may file a claim for refund</p>	<p>has the burden of establishing that he or she was entitled to claim the partial exemption.</p> <p>For the period commencing on January 1, 1994, and ending on December 31, 1994, a qualified person may claim the partial exemption on qualified purchases from an in-state retailer or an out-of-state retailer obligated to collect the use tax by furnishing the retailer with a manufacturer's exemption certificate on or before March 31, 1995. The retailer must refund the tax directly to the purchaser or, at the purchaser's sole option, the purchaser may be credited with such amount. In the event that the retailer has already reported and paid the tax to the Board, the retailer must file a written claim for refund on or before April 30, 1995.</p> <p>(C) A person who self-reported and paid <u>sales or</u> use tax on a qualified purchase from a retailer not engaged in business in this state, and who failed to claim the partial use tax exemption as provided by this regulation may file a</p>	<p>has the burden of establishing that he or she was entitled to claim the partial exemption.</p> <p>For the period commencing on January 1, 1994, and ending on December 31, 1994, a qualified person may claim the partial exemption on qualified purchases from an in-state retailer or an out-of-state retailer obligated to collect the use tax by furnishing the retailer with a manufacturer's exemption certificate on or before March 31, 1995. The retailer must refund the tax directly to the purchaser or, at the purchaser's sole option, the purchaser may be credited with such amount. In the event that the retailer has already reported and paid the tax to the Board, the retailer must file a written claim for refund on or before April 30, 1995.</p> <p>(C) A person who self-reported and paid <u>sales or</u> use tax on a qualified purchase from a retailer not engaged in business in this state, and who failed to claim the partial use tax exemption as provided by this regulation may file a</p>	<p>failed to claim the partial use tax exemption.</p> <p>It is staff's view that the legislature did not intend to allow claims for refund of sales tax when the manufacturer's exemption is not timely claimed. The legislature's enactment of a refund provision for the MIC and not for the manufacturer's exemption indicates a legislative intent not to allow such refunds.</p>

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	equal to the amount of the partial exemption that he or she could have claimed pursuant to this regulation. The procedure for such a claim shall be the same as for other claims for refund filed pursuant to Revenue and Taxation Code section 6901. A person filing a claim for refund of the partial use tax exemption has the burden of establishing that he or she was entitled to claim the partial exemption with respect to the amount of refund claimed under this part.	claim for refund equal to the amount of the partial exemption that he or she could have claimed pursuant to this regulation. The procedure for such a claim shall be the same as for other claims for refund filed pursuant to Revenue and Taxation Code section 6901. A person filing a claim for refund of the partial use tax exemption has the burden of establishing that he or she was entitled to claim the partial exemption with respect to the amount of refund claimed under this part.	claim for refund equal to the amount of the partial exemption that he or she could have claimed pursuant to this regulation. The procedure for such a claim shall be the same as for other claims for refund filed pursuant to Revenue and Taxation Code section 6901. A person filing a claim for refund of the partial use tax exemption has the burden of establishing that he or she was entitled to claim the partial exemption with respect to the amount of refund claimed under this part.	
Action 2 – Consumables	(c) Definitions. (9) "Tangible personal property" does not include any of the following: (A) Real property, including tangible personal property to be incorporated into an improvement to real property, except for "special purpose buildings and foundations" as defined in subsection (c)(10)(D) and conveyance systems and assembly lines as provided in subsection (c)(10)(A). (B) Consumables with a normal useful	(c) Definitions. (9) "Tangible personal property" does not include any of the following: (A) Real property, including tangible personal property to be incorporated into an improvement to real property, except for "special purpose buildings and foundations" as defined in subsection (c)(10)(D) and conveyance systems and assembly lines as provided in subsection (c)(10)(A). (B) Consumables with a normal useful	(c) Definitions. (9) "Tangible personal property" does not include any of the following: (A) Real property, including tangible personal property to be incorporated into an improvement to real property, except for "special purpose buildings and foundations" as defined in subsection (c)(10)(D) and conveyance systems and assembly lines as provided in subsection (c)(10)(A). (B) Consumables with a normal useful	Industry 1 proposes to amend subsections (c)(9)(B) and (c)(10)(B) to establish a rebuttable presumption to the provisions that classify an item as a consumable item that does not qualify for the partial tax exemption. In addition industry proposes to eliminate the \$250 threshold that classifies purchases as

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	<p>life of less than one year, except as provided in subsection (c)(10)(E). Tangible personal property that the qualified person treats as having a normal useful life of less than one year for state income or franchise tax purposes or tangible personal property which is acquired by the qualified person at a unit cost of \$250 or less is tangible personal property with a normal useful life of less than one year for purposes of this regulation.</p> <p>(C) Furniture, inventory, equipment used in the extraction process, equipment used to store raw materials that have not yet entered or commenced the manufacturing process, or equipment used to store finished products that have completed the manufacturing process. The extraction process includes such severance activities as mining, oil and gas extraction.</p> <p>(D) Any property for which a credit is</p>	<p>life of less than one year, except as provided in subsection (c)(10)(E). <u>For purposes of this regulation, it shall be presumed t</u>Tangible personal property that the qualified person treats as having a normal useful life of less than one year for state income or franchise tax purposes or tangible personal property which is acquired by the qualified person at a unit cost of \$250 or less is tangible personal property with a normal useful life of less than one year for purposes of this regulation. <u>This presumption may be rebutted by evidence satisfactory to the board.</u></p> <p>(C) Furniture, inventory, equipment used in the extraction process, equipment used to store raw materials that have not yet entered or commenced the manufacturing process, or equipment used to store finished products that have completed the manufacturing process. The extraction process includes such severance activities as mining, oil and gas extraction.</p> <p>(D) Any property for which a credit is</p>	<p>life of less than one year, except as provided in subsection (c)(10)(E). Tangible personal property that the qualified person treats as having a normal useful life of less than one year for state income or franchise tax purposes or tangible personal property which is acquired by the qualified person at a unit cost of \$250 or less is tangible personal property with a normal useful life of less than one year for purposes of this regulation.</p> <p>(C) Furniture, inventory, equipment used in the extraction process, equipment used to store raw materials that have not yet entered or commenced the manufacturing process, or equipment used to store finished products that have completed the manufacturing process. The extraction process includes such severance activities as mining, oil and gas extraction.</p> <p>(D) Any property for which a credit is</p>	<p>having a normal useful life of less than one year. Industry's contention is that the \$250 threshold constitutes an artificial "bright line" and is not supported by the statute.</p> <p>Staff and Industry 2 favor no change to these provisions, in line with concerns expressed by retailers about the undue burden placed on them if exemption certificates are allowed to be issued for small items.</p>

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	<p>claimed under either section 17053.49 or 23649 of the Revenue and Taxation Code.</p> <p>(10) "Tangible personal property" includes but is not limited to the following:</p> <p>(A) Machinery and equipment within the meaning of subsection (a)(6) of Regulation 1521 of the Sales and Use Tax Regulations, including component parts and contrivances such as belts, shafts, moving parts, and operating structures. The term also includes conveyance systems and assembly lines without regard to the manner of affixation to real property.</p> <p>(B) All equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, without limitation, computers, data processing equipment, and computer software, including both operating programs and application programs, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased</p>	<p>claimed under either section 17053.49 or 23649 of the Revenue and Taxation Code.</p> <p>(10) "Tangible personal property" includes but is not limited to the following:</p> <p>(A) Machinery and equipment within the meaning of subsection (a)(6) of Regulation 1521 of the Sales and Use Tax Regulations, including component parts and contrivances such as belts, shafts, moving parts, and operating structures. The term also includes conveyance systems and assembly lines without regard to the manner of affixation to real property.</p> <p>(B) All equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, without limitation, computers, data processing equipment, and computer software, including both operating programs and application programs, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased</p>	<p>claimed under either section 17053.49 or 23649 of the Revenue and Taxation Code.</p> <p>(10) "Tangible personal property" includes but is not limited to the following:</p> <p>(A) Machinery and equipment within the meaning of subsection (a)(6) of Regulation 1521 of the Sales and Use Tax Regulations, including component parts and contrivances such as belts, shafts, moving parts, and operating structures. The term also includes conveyance systems and assembly lines without regard to the manner of affixation to real property.</p> <p>(B) All equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, without limitation, computers, data processing equipment, and computer software, including both operating programs and application programs, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased</p>	

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	separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the taxpayer or another party. Any repair and replacement parts that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall have a useful life of less than one year for purposes of this regulation.	separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the taxpayer or another party. Any repair and replacement parts that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall <u>be presumed to have a useful life of less than one year for purposes of this regulation. This presumption may be rebutted by evidence satisfactory to the board.</u>	separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the taxpayer or another party. Any repair and replacement parts that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall have a useful life of less than one year for purposes of this regulation.	
Action 3 – Definition of Establishment	(c) Definitions. (6) "Qualified person" means any person that satisfies the requirements of both subsections (c)(6)(A) and (c)(6)(B) below with regard to the trade or business in which the property will be placed into service in the use qualifying the property for this partial exemption: (B) A qualified person must be engaged in those manufacturing lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the	(c) Definitions. (6) "Qualified person" means any person that satisfies the requirements of both subsections (c)(6)(A) and (c)(6)(B) below with regard to the trade or business in which the property will be placed into service in the use qualifying the property for this partial exemption: (B) A qualified person must be engaged in those manufacturing lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the	(c) Definitions. (6) "Qualified person" means any person that satisfies the requirements of both subsections (c)(6)(A) and (c)(6)(B) below with regard to the trade or business in which the property will be placed into service in the use qualifying the property for this partial exemption: (B) A qualified person must be engaged in those manufacturing lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the	Industry 1 proposes changing the definition of "establishment" in subsections (c)(6)(B)(1) and (c)(6)(B)(2) to correspond to the definition used in Regulation 1532, <i>Teleproduction and Other Postproduction Services</i> . Industry contends the definition found in 1532(c)(2)(C) is the most current definition and is easier

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	<p>United States Office of Management and Budget, 1987 edition. For purposes of this subsection:</p> <p>1. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon value of production. The term "establishment" means an economic unit, generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. The following will generally constitute an "establishment": a factory, mill, store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office.</p> <p>2. For purposes of determining the "establishment" or "establishments" of a trade or business:</p>	<p>United States Office of Management and Budget, 1987 edition. For purposes of this subsection:</p> <p>1. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon value of production. The term "establishment" means an economic unit, generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. The following will generally constitute an "establishment": a factory, mill, store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office.</p> <p>2. For purposes of determining the "establishment" or "establishments" of a trade or business:</p>	<p>United States Office of Management and Budget, 1987 edition. For purposes of this subsection:</p> <p>1. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon value of production. The term "establishment" means an economic unit, generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. The following will generally constitute an "establishment": a factory, mill, store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office.</p> <p>2. For purposes of determining the "establishment" or "establishments" of a trade or business:</p>	<p>with which to comply.</p> <p>Staff does not agree, noting that the current definition of "establishment" in Regulation 1525.2 is taken directly from the SIC manual, and is the appropriate definition since taxpayers may only qualify for the manufacturer's exemption based on the definitions found in the SIC.</p>

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	<p>a. Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be "significant" for purposes of this paragraph whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the taxpayer's total dollar value of</p>	<p>a. Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be "significant" for purposes of this paragraph whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the taxpayer's total dollar value of</p>	<p>a. Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be "significant" for purposes of this paragraph whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the taxpayer's total dollar value of</p>	

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	<p>payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status.</p> <p>b. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments.</p> <p>c. Where a person conducts business at more than one establishment within the meaning of this subsection, then that person shall be considered to be a "qualified person" for purposes of this regulation only as to those purchases that are intended to be used and are actually used in those lines of business that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</p>	<p>payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status.</p> <p>b. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments.</p> <p>c. Where a person conducts business at more than one establishment within the meaning of this subsection, then that person shall be considered to be a "qualified person" for purposes of this regulation only as to those purchases that are intended to be used and are actually used in those lines of business that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</p> <p><u>1 For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the</u></p>	<p>payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status.</p> <p>b. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments.</p> <p>c. Where a person conducts business at more than one establishment within the meaning of this subsection, then that person shall be considered to be a "qualified person" for purposes of this regulation only as to those purchases that are intended to be used and are actually used in those lines of business that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</p> <p><u>1 For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the</u></p>	

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		<p><u>classification of the line or lines of business will be based on the establishment's primary activity based upon gross revenues.</u></p> <p><u>2 "Establishment" is defined as the smallest operating unit for which records provide information on the revenues and cost of operations incurred in those lines of business activities that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</u></p> <p><u>a The services may be provided to other divisions within the same entity or to related parties with or without direct compensation.</u></p> <p><u>b Establishments may include, but are not limited to, departments, divisions, subdivisions and product lines.</u></p>	<p><u>classification of the line or lines of business will be based on the establishment's primary activity based upon gross revenues.</u></p> <p><u>2 "Establishment" is defined as the smallest operating unit for which records provide information on the revenues and cost of operations incurred in those lines of business activities that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.</u></p> <p><u>a The services may be provided to other divisions within the same entity or to related parties with or without direct compensation.</u></p> <p><u>b Establishments may include, but are not limited to, departments, divisions, subdivisions and product lines.</u></p>	

Regulation 1525.2. Manufacturing Equipment.

Reference: Section 6377, Revenue and Taxation Code.

(a) Partial Exemption for Property Purchased for Use in the Manufacturing Process. Section 6377 of the Revenue and Taxation Code provides a partial exemption from sales and use tax for certain properties described in this regulation. For the period commencing on January 1, 1994, and ending on December 31, 1994, the partial exemption applies to the taxes imposed by the state (6%), but does not apply to the taxes imposed by counties, cities, and districts pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law (Rev. & Tax. Code §§ 7200, et seq.) or the Transactions and Use Tax Law (Rev. & Tax. Code §§ 7251, et seq.). Commencing on January 1, 1995, the partial exemption applies to the taxes imposed by sections 6051, 6051.3, 6201, and 6201.3 of the Revenue and Taxation Code (5%), but does not apply to the taxes imposed pursuant to sections 6051.2 and 6201.2 of the Revenue and Taxation Code, the Bradley-Burns Uniform Local Sales and Use Tax Law, the Transactions and Use Tax Law, or section 35 of article XIII of the California Constitution.

Subject to the limitations set forth above, this partial exemption applies to gross receipts from the sale, storage, use, or other consumption in this state of the following items:

(1) Tangible personal property purchased for use by a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of property, beginning at the point that raw materials are received by the qualified person and introduced into the process and ending at the point at which the property has been altered to its completed form, including packaging, if required. For purposes of this regulation:

(A) Raw materials will be considered to have been introduced into the process when the raw materials are stored on the same premises where the qualified person's manufacturing activities are conducted. Raw materials that are stored on premises other than where the qualified person's manufacturing activities are conducted, however, will not be considered to have been introduced into the process for purposes of this regulation.

(B) For purposes of this regulation, the term "packaging" includes only that packaging necessary to prepare the goods for delivery to and placement in the qualified person's finished goods inventory, or to prepare the goods so that they are suitable for delivery to and placement in finished goods inventory. Any additional packaging, such as that packaging necessary to consolidate the goods prior to shipping or to protect them during transportation, shall not be considered to be "packaging" for purposes of this regulation.

(2) Tangible personal property purchased for use by a qualified person to be used primarily in research and development as defined in subsection (c)(8).

(3) Tangible personal property purchased for use by a qualified person to be used primarily to maintain, repair, measure, or test any property described in subsections (a)(1) or (a)(2).

(4) Tangible personal property purchased for use by a contractor purchasing that property either as an agent of a qualified person or for the contractor's own account and subsequent resale to a qualified person for use in the performance of a construction contract for the qualified person who will use the tangible personal property as an integral part of the manufacturing, processing,

refining, fabricating, or recycling process, or as a research or storage facility for use in connection with the manufacturing process.

(b) Property Used Primarily in Administration, General Management, or Marketing. Notwithstanding any other provision of this regulation, this partial exemption shall not apply to any tangible personal property that is used primarily in administration, general management, or marketing. For purposes of this subsection:

(1) Tangible personal property is used primarily in administration, general management, or marketing when it is used 50 percent or more of the time in one or more of those activities.

(2) Tangible personal property used primarily to clean and maintain the factory floor of a manufacturing facility is used primarily in a stage of the manufacturing of property and is not used primarily in administration, general management, or marketing.

(3) Fire safety equipment that is tangible personal property and that is used primarily at and in connection with the factory floor of a manufacturing facility is used primarily in a stage of the manufacturing of property and is not used primarily in administration, general management, or marketing.

(c) Definitions. For purposes of this regulation:

(1) "Fabricating" means to make, build, create, produce, or assemble components or property to work in a new or different manner.

(2) "Manufacturing" means the activity of converting or conditioning property by changing the form, composition, quality, or character of the property for ultimate sale at retail or for use in the manufacturing of a product to be ultimately sold at retail. Manufacturing includes any improvements to tangible personal property that result in a greater service life or greater functionality than that of the original property. For purposes of this regulation, "greater functionality" means that the tangible personal property has been improved so that it can perform new or different functions than the original property. Manufacturing includes logging, that is, the felling of timber, but does not include tree farming. Manufacturing does not include crop harvesting. Provided that the activity constitutes a "sale" as that term is used in subdivision (b) of section 6006 of the Revenue and Taxation Code, the tangible personal property need not be owned by the qualified person in order for the activity to qualify as manufacturing for purposes of this regulation.

(3) "Primarily" means that the tangible personal property is used 50 percent or more of the time in the designated activity or activities.

(4) "Process" means the period beginning at the point at which any raw materials are received by the qualified person and are introduced into the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling activity of the qualified person has altered tangible personal property to its completed form including packaging, if required. Raw materials shall be considered to have been introduced into the process when the raw materials are

stored on the same premises where the qualified person's manufacturing, process, refining, or recycling activity is conducted. Raw materials that are stored on premises other than where the qualified person's manufacturing, processing, refining, fabricating, or recycling activity is conducted, shall not be considered to have been introduced into the manufacturing, processing, refining, fabricating, or recycling process.

(5) "Processing" means the physical application of materials and labor to modify or change the characteristics of property.

(6) "Qualified person" means any person that satisfies the requirements of both subsections (c)(6)(A) and (c)(6)(B) below with regard to the trade or business in which the property will be placed into service in the use qualifying the property for this partial exemption:

(A) A "qualified person" must have first commenced trade or business activities in a new trade or business in this state on or after January 1, 1994. For purposes of this subsection, the term "activities" means trade or business activities. In determining whether or not a person is qualified within the meaning of this subsection, the following rules apply:

1. The term "trade or business activities" does not mean the mere formation or organization of a corporation or other business entity that is intended to conduct a trade or business. Instead, a corporation or business entity first conducts activities when it first starts or commences the trade or business for which it was organized. The acquisition of operating assets that are necessary to the type of business contemplated, however, will constitute commencing activities. The term "operating assets" as used in this subsection means assets that are in a state of readiness to be placed in service within a reasonable time period following their acquisition.

2. Notwithstanding any other provision of this subsection, a person will not be considered to have first commenced activities in a new trade or business in this state on or after January 1, 1994, if, at any time within the 36 months preceding that date, that person, or any related person, was required to have secured a seller's permit under section 6066 of the Revenue and Taxation Code for that trade or business, or any other trade or business classified under the same division of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition (the "Manual"). For purposes of this regulation, the term "division" means a division as that term is used in the Manual.

3. A trade or business is not a new trade or business in this state if, within the 36 months preceding the date that activities were first commenced in that trade or business in this state, either the person claiming the partial exemption, or any related person, had conducted any activities in this state in any trade or business classified under the same division of the Manual as that trade or business.

4. Where a person, or any related person, is engaged in one or more trade or business activities in this state, or has been engaged in one or more trade or business activities in this state within the preceding 36 months (a "prior trade or business activity"), and thereafter commences an additional trade or business activity in this state, the additional trade or business activity shall only be treated as a new trade or business if the additional trade or business activity is classified

under a different division of the Manual than are any of the person's (or any related person's) current or prior trade or business activities in this state within the preceding 36 months.

5. Where a person, including all related persons, is engaged in trade or business activities wholly outside of this state and that person first commences doing business in this state (within the meaning of section 23101 of the Revenue and Taxation Code) after December 31, 1993 (other than by purchase or other acquisition described in subsection (c)(6)(A)6.), the newly commenced trade or business activity in this state shall be treated as a new trade or business for purposes of this subsection.

6. On or after January 1, 1995, notwithstanding anything else set forth in this subsection, in any case where a person purchases or otherwise acquires all or any portion of the assets of an existing trade or business (irrespective of the form of the entity) that is doing business in this state (within the meaning of section 23101 of the Revenue and Taxation Code), the trade or business thereafter conducted by that person (or any related person) shall not be treated as a new trade or business if the aggregate fair market value of the acquired assets (including real, personal, tangible, and intangible property) used by that person (or any related person) in the conduct of his or her trade or business exceeds 20 percent of the aggregate fair market value of the total assets of the person (or any related person) being used in the same trade or business both within and without this state. For purposes of this subsection only:

a. The determination of the relative fair market values of the acquired assets and the total assets shall be made as of the last day of the month following the quarterly period in which the person (or any related person) first uses any of the acquired trade or business assets in his or her business activity.

b. Any acquired assets that constitute property described in section 1221(1) of the Internal Revenue Code in the hands of the transferor shall not be treated as assets acquired from an existing trade or business, unless those assets also constitute property described in section 1221(1) of the Internal Revenue Code in the hands of the acquiring person (or any related person).

c. The trade or business conducted in this state by the acquiring person after the asset acquisition date shall be considered to be the same as an out-of-state trade or business conducted or previously conducted by the acquiring person (or any related person) only if the trade or business activities of both companies are or would be classified in the same division of the Manual.

d. An acquired trade or business will not be considered to have been acquired as an existing trade or business for purposes of this subsection if it is acquired either: (1) from a liquidation sale of assets pursuant to a bankruptcy filed under Chapter 7 of the United States Bankruptcy Code; or (2) pursuant to a creditor's execution or foreclosure sale of a secured interest in the assets of the trade or business.

e. Example No. 1: Corporation X is doing business wholly outside of this state in the trade or business of manufacturing automobiles. The total fair market value of the total assets of this trade or business is \$100,000,000. Then, on or after January 1, 1994, Corporation X acquires all

of the assets of an automobile manufacturing business in this state with a fair market of \$5,000,000 and immediately uses the acquired assets in its automobile manufacturing trade or business. Thereafter, between the date of acquisition and the last day of the month following the quarterly period during which the acquisition occurred, Corporation X acquires another \$1,000,000 in assets for use in the automobile manufacturing business in this state. Under these assumed facts, the conditions set forth in this subparagraph will not serve to disqualify Corporation X from the partial exemption since the fair market value of the acquired assets does not exceed 20 percent ($\$5,000,000/\$106,000,000$) of the aggregate fair market value of the total assets of the trade or business being conducted by Corporation X; and neither Corporation X nor any related person had conducted any trade or business activities in this state within the preceding 36 months.

f. Example No. 2: Assume the same facts as in Example No. 1 above, but in this case, prior to acquiring the assets of the automobile manufacturing business in this state, Corporation X was solely and exclusively in the trade or business of providing data processing services. After the acquisition of the assets by Corporation X, however, the acquired assets will continue to be used in the automobile manufacturing business in this state. Assume further that no additional purchases are made after the date of acquisition. Under these assumed facts, since data processing services and automobile manufacturing are classified in different divisions of the Manual, the partial exemption will not be available to Corporation X because the fair market value of the acquired assets exceeds 20 percent ($\$5,000,000/\$5,000,000$) of the aggregate fair market value of the total assets held by Corporation X in the same trade or business.

7. In any case where the legal form under which a trade or business activity is being conducted is changed, the change in form shall be disregarded and the determination of whether the trade or business activity is a new business shall be made by treating the person as having purchased or otherwise acquired all or any portion of the assets of an existing trade or business. For purposes of this subsection only:

a. Example No. 1: Corporation X is doing business in this state. One of its trade or business activities in this state is manufacturing automobiles. After January 1, 1994, for consideration, Corporation X transfers all of the assets used in the trade or business of manufacturing automobiles to a newly-formed, wholly-owned subsidiary known as Corporation Y. For purposes of applying this regulation, this transaction shall be treated as an acquisition of an existing trade or business by Corporation Y.

b. Example No. 2: Partnership A is a manufacturer doing business in this state. After January 1, 1994, for consideration, Partnership A transfers all of its assets to a newly-formed corporation known as Corporation B. Corporation B is owned by the partners of Partnership A in the same proportionate ownership interests as their respective ownership interests in the partnership. For purposes of applying this regulation, this transaction shall be treated as an acquisition of an existing trade or business by Corporation B.

8. For purposes of this subsection, a person is a "related person" if that person is or previously was related to the qualified person within the meaning of either section 267 or 318 of the Internal Revenue Code.

9. The term "acquire" shall include any gift, inheritance, transfer incident to divorce, or any other transfer, whether or not for consideration.

(B) A qualified person must be engaged in those manufacturing lines of business described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition. For purposes of this subsection:

1. For purposes of classifying a line or lines of business, the economic unit shall be the "establishment" and the classification of the line or lines of business will be based on the establishment's single most predominant activity based upon value of production. The term "establishment" means an economic unit, generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. The following will generally constitute an "establishment": a factory, mill, store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office.

2. For purposes of determining the "establishment" or "establishments" of a trade or business:

a. Where distinct and separate economic activities are performed at a single physical location, such as construction activities operated out of the same physical location as a lumber yard, each activity should be treated as a separate establishment where: (i) no one industry description in the classification includes such combined activities; (ii) the employment in each such economic activity is significant; and (iii) separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting. For purposes of this paragraph, whether or not employment in an economic activity is significant shall be based upon all of the facts and circumstances. Nevertheless, employment in an economic activity will be considered to be "significant" for purposes of this paragraph whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the taxpayer's total dollar value of payroll at a single physical location, is attributable to the economic activity being tested for separate establishment status.

b. An establishment is not necessarily identical with the enterprise or company which may consist of one or more establishments. Also, an establishment is to be distinguished from subunits of the establishment such as departments.

c. Where a person conducts business at more than one establishment within the meaning of this subsection, then that person shall be considered to be a "qualified person" for purposes of this regulation only as to those purchases that are intended to be used and are actually used in those lines of business that are described in Codes 2011 to 3999, inclusive, of the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.

(7) "Refining" means the process of converting a natural resource to an intermediate or finished product.

(8) "Research and development" means those activities that are described in section 174 of the Internal Revenue Code or in any regulations thereunder.

(9) "Tangible personal property" does not include any of the following:

(A) Real property, including tangible personal property to be incorporated into an improvement to real property, except for "special purpose buildings and foundations" as defined in subsection (c)(10)(D) and conveyance systems and assembly lines as provided in subsection (c)(10)(A).

(B) Consumables with a normal useful life of less than one year, except as provided in subsection (c)(10)(E). Tangible personal property that the qualified person treats as having a normal useful life of less than one year for state income or franchise tax purposes or tangible personal property which is acquired by the qualified person at a unit cost of \$250 or less is tangible personal property with a normal useful life of less than one year for purposes of this regulation.

(C) Furniture, inventory, equipment used in the extraction process, equipment used to store raw materials that have not yet entered or commenced the manufacturing process, or equipment used to store finished products that have completed the manufacturing process. The extraction process includes such severance activities as mining, oil and gas extraction.

(D) Any property for which a credit is claimed under either section 17053.49 or 23649 of the Revenue and Taxation Code.

(10) "Tangible personal property" includes but is not limited to the following:

(A) Machinery and equipment within the meaning of subsection (a)(6) of Regulation 1521 of the Sales and Use Tax Regulations, including component parts and contrivances such as belts, shafts, moving parts, and operating structures. The term also includes conveyance systems and assembly lines without regard to the manner of affixation to real property.

(B) All equipment or devices used or required to operate, control, regulate, or maintain the machinery, including, without limitation, computers, data processing equipment, and computer software, including both operating programs and application programs, together with all repair and replacement parts with a useful life of one or more years therefor, whether purchased separately or in conjunction with a complete machine and regardless of whether the machine or component parts are assembled by the taxpayer or another party. Any repair and replacement parts that the qualified person treats as having a useful life of less than one year for state income or franchise tax purposes shall have a useful life of less than one year for purposes of this regulation.

(C) Property used in pollution control that meets or exceeds standards established by this state or any local or regional governmental agency within this state.

(D) Special purpose buildings and foundations that (i) are used as an integral part of the manufacturing, processing, refining, or fabricating process, or (ii) constitute a research facility

used during the manufacturing process as an integral part of a manufacturing, processing, refining, or fabricating activity, or (iii) constitute a storage facility used during the manufacturing process as an integral part of a manufacturing, processing, refining, or fabricating activity. For purposes of this subsection:

1. For purposes of this subsection, "special purpose building and foundation" means only a building and the foundation immediately underlying the building that is specifically designed and constructed or reconstructed for the installation, operation, and use of specific machinery and equipment with a special purpose, which machinery and equipment, after installation, will become affixed to or a fixture of the real property, and the construction or reconstruction of which is specifically designed and used exclusively for the specified purposes as set forth in subsection (a)(1) of this regulation (the qualified purpose).

2. A building is specifically designed and constructed or modified for a qualified purpose if it is not economic to design and construct the building for the intended purpose and then use the structure for a different purpose.

3. A building is used exclusively for a qualified purpose only if its use does not include a use for which it was not specifically designed and constructed or modified. Incidental use of a building for nonqualified purposes does not preclude the building from being a special purpose building. "Incidental use" means a use which is both related and subordinate to the qualified purpose. A use is not subordinate if more than one-third of the total usable volume of the building is devoted to a use which is not a qualifying purpose.

4. In the event an entire building does not qualify as a special purpose building, a taxpayer may establish that a portion of a building, and the foundation immediately underlying the portion, qualifies for treatment as a special purpose building and foundation if the portion satisfies all of the definitional provisions in this subsection.

5. Buildings and foundations that do not meet the definition of a special purpose building and foundation set forth above include, but are not limited to, buildings designed and constructed or reconstructed principally to function as a general purpose manufacturing, industrial, or commercial building; research facilities that are used primarily prior to or after, or prior to and after, the manufacturing process; or storage facilities that are used primarily prior to or after, or prior to and after, completion of the manufacturing process.

6. For purposes of this subsection, the term "integral part" means that the special purpose building or foundation (i) is used directly in the activity qualifying for the partial exemption from sales and use tax and (ii) is essential to the completeness of that activity. In determining whether property is used as an integral part of manufacturing, all properties used by the qualified person in processing the raw materials into the final product are properties used as an integral part of manufacturing.

(E) Fuels used or consumed in the manufacturing process.

(F) Property used in recycling.

(11) "Standard Industrial Classification" means a Standard Industrial Classification in the Standard Industrial Classification Manual published by the United States Office of Management and Budget, 1987 edition.

(d) Three-Year Limitation. Notwithstanding any other provision of this regulation, once a person has conducted business activities in a new trade or business for three or more years, that person will no longer be considered to be in a "new trade or business," nor "qualified" for this partial exemption.

(e) Taxes as to Which the Partial Exemption Does Not Apply. This partial exemption does not apply to any tax levied by a county, city, or district pursuant to, or in accordance with, either the Bradley-Burns Uniform Local Sales and Use Tax Law (Rev. & Tax. Code §§ 7200 et seq.) or the Transactions and Use Tax Law (Rev. & Tax Code §§ 7251 et seq.).

On or after January 1, 1995, this partial exemption shall not apply to any tax levied pursuant to section 6051.2 and 6201.2 of the Revenue and Taxation Code, or pursuant to section 35 of article XIII of the California Constitution.

(f) Exemption Certificates. Except as otherwise set forth in subsection (f)(3), to claim the partial exemption provided by this regulation, a person must be both pre-qualified by the Board and either registered to hold a seller's permit or maintain a consumer use tax account. Exemption certificates issued to qualified persons will contain a control number and expiration date for verifying a person's status as a qualified person. An exemption certificate is not valid if it has not been issued by the Board or if it is accepted after the expiration date on the certificate. Qualified persons who have been pre-qualified may reproduce the issued certificates as needed for their qualifying purchases.

The exemption certificates issued by the Board will be in substantially the same form as they appear in Appendices A and B of this regulation. Qualified persons who purchase or lease tangible personal property from an in-state retailer or an out-of-state retailer obligated to collect the use tax must provide the retailer with a manufacturer's exemption certificate in order to claim the partial exemption. The manufacturer's use tax declaration must be completed by a qualified person to claim a partial exemption from use tax on purchases of tangible personal property from an out-of-state retailer not obligated to collect the use tax.

(1) Manufacturer's Exemption Certificates.

(A) In General. Except as otherwise provided in subsections (f)(1)(B) or (f)(3) of this regulation, or in section 6902.2 of the Revenue and Taxation Code, a partial exemption from sales or use tax shall not be allowed unless:

1. The qualified person furnishes the retailer with a manufacturer's exemption certificate no later than 60 days after the date of the purchase; and

2. The retailer timely files a sales and use tax return claiming the partial exemption and, together with that timely return, provides the Board with a copy of the manufacturer's exemption certificate.

(B) Exclusions. Except as provided in subsection (f)(1)(C) below, retailers claiming the partial exemption in timely filed returns will not be required to furnish the Board with copies of manufacturer's exemption certificates for sales or leases of tangible personal property made by a retailer at any single physical location to a single qualified purchaser that do not exceed an aggregate total of \$25,000 during a single calendar quarter. Regardless of the total quarterly sales per purchaser, however, when necessary for the efficient administration of the sales and use tax law, the Board may, on 30 days' written notice, require a retailer to commence furnishing the Board with copies of all certificates on a quarterly basis pursuant to subsection (f)(1)(A)2.

(C) Retention And Availability Of Certificates. A retailer must retain each manufacturer's exemption certificate received from a qualified person for a period of four years from the date on which the retailer claims a partial exemption based on the exemption certificate.

Within 45 days of the Board's request, retailers must furnish to the Board any and all manufacturer's exemption certificates, or copies thereof, received from qualified persons, including exemption certificates for aggregate sales or leases of \$25,000 or less to a single qualified person made at any single physical location of the retailer during a single calendar quarter.

(2) Manufacturer's Use Tax Declaration. Except as provided in section 6902.2 of the Revenue and Taxation Code, a partial exemption from the use tax shall not be allowed unless the qualified person:

(A) Timely files a sales and use tax return or consumer use tax return for the period in which the purchase occurs and timely pays any applicable tax in full that is excluded from this partial exemption as provided in subsection (e) of this regulation; and

(B) Attaches a completed manufacturer's use tax declaration to the sales and use tax return or consumer use tax return that is timely filed with the Board.

(3) Waiver of Partial Exemption. Except as specifically set forth in section 6902.2 of the Revenue and Taxation Code:

(A) Failure to claim the partial exemption by furnishing the retailer with a manufacturer's exemption certificate within 60 days after an otherwise qualified purchase constitutes a waiver of the partial exemption for that purchase and, as a consequence, the partial exemption cannot be claimed on that purchase.

(B) Failure to file a timely return for an otherwise qualified purchase from a retailer not engaged in business in this state, or failure to attach a completed manufacturer's declaration to such a timely filed return, does not constitute a waiver of the use tax partial exemption for that purchase. A person who fails to file a timely return or attach a completed manufacturer's declaration to a timely return for an otherwise qualified purchase has the burden of establishing that he or she was entitled to claim the partial exemption.

For the period commencing on January 1, 1994, and ending on December 31, 1994, a qualified person may claim the partial exemption on qualified purchases from an in-state retailer or an out-of-state retailer obligated to collect the use tax by furnishing the retailer with a manufacturer's exemption certificate on or before March 31, 1995. The retailer must refund the tax directly to the purchaser or, at the purchaser's sole option, the purchaser may be credited with such amount. In the event that the retailer has already reported and paid the tax to the Board, the retailer must file a written claim for refund on or before April 30, 1995.

(C) A person who self-reported and paid use tax on a qualified purchase from a retailer not engaged in business in this state, and who failed to claim the partial use tax exemption as provided by this regulation may file a claim for refund equal to the amount of the partial exemption that he or she could have claimed pursuant to this regulation. The procedure for such a claim shall be the same as for other claims for refund filed pursuant to Revenue and Taxation Code section 6901. A person filing a claim for refund of the partial use tax exemption has the burden of establishing that he or she was entitled to claim the partial exemption with respect to the amount of refund claimed under this part.

(4) Construction Contractors. In the case of a contractor who purchases property as an agent of a qualified person or for subsequent resale to a qualified person, the qualified person is deemed to be the purchaser for purposes of this subsection.

(g) Conversion of Property to a Use Not Qualifying for the Partial Exemption. Notwithstanding subsection (a), this partial exemption shall not apply to any sale of, or the storage, use, or other consumption in this state of property that, within one year from the later of the date of purchase of the property or the date that the property was first placed into service by the purchaser in an exempt use, is: (i) removed from this state, (ii) converted from an exempt use under this regulation to some other use not qualifying for the partial exemption, or (iii) used in a manner not qualifying for the partial exemption under this regulation. For purposes of this subsection, property is converted to a use not qualifying for the partial exemption if, without limitation, the property, or any interest in the property, or possession or control of the property, is either directly or indirectly sold, transferred, leased, or assigned to a person who is not a qualified person on the date the property is sold, transferred, leased, or assigned to such nonqualified person. In the case of a corporation that, as a qualified person, purchases tangible personal property under this partial exemption and then, within one year from the later of the date of purchase of the property or the date that the property was first placed into service by that corporation in an exempt use, either directly or indirectly transfers that property to its parent corporation that is not a qualified person on the date of the transfer of property to the parent corporation, that property has been converted to a use not qualifying for the partial exemption.

(h) Purchaser's Liability for the Payment of Sales Tax. If a purchaser submits a copy of a manufacturer's exemption certificate to the seller, and then within one year from the later of the date of purchase of the property or the date that the property was first placed into service by the purchaser in an exempt use, the purchaser either (i) removes that property from this state, (ii) converts that property from an exempt use under this regulation to some other use not qualifying for the partial exemption, or (iii) uses that property in a manner not qualifying for the partial exemption under this regulation, then, in that event, the purchaser shall be liable for payment of sales tax, with applicable interest, to the same extent as if the purchaser were a retailer making a

retail sale of the property at the time the property was so removed, converted, or used; and the sales price of the property to the purchaser shall be deemed to be the gross receipts from that retail sale. For purposes of this subsection, property is converted to a use not qualifying for the partial exemption if, without limitation, the property, or any interest in the property, or possession or control of the property, is either directly or indirectly sold, transferred, leased, or assigned to a person who is not a qualified person on the date the property is sold, transferred, leased, or assigned to such nonqualified person.

(i) Leases to Qualifying Persons.

(1) Leases--In General. Subject to all the limitations and conditions set forth in this regulation and regulation 1525.3, this partial exemption may apply to rental receipts paid by a qualified person with respect to a lease of tangible personal property to the qualified person, which tangible personal property is used as set forth in subsections (a)(1), (a)(2), (a)(3), or (a)(4) of this regulation.

(2) Leases--Acquisition Sale and Leaseback. A person will be regarded as having paid sales tax reimbursement or use tax with respect to that person's purchase of property, within the meaning of those words as they are used in section 6010.65 of the Revenue and Taxation Code, if the person has paid all applicable taxes with respect to the acquisition of the property, notwithstanding the fact that the sale and purchase of the property may have been subject to the partial exemption from tax provided by this regulation.

(3) Subsequent Lease of Property Acquired Subject to Partial Exemption. If a person has acquired property subject to the partial exemption provided by this regulation and has paid all applicable taxes at that acquisition, the property will be regarded as property as to which sales tax reimbursement or use tax has been paid, and the subsequent lease of that property will not be subject to tax measured by rental receipts.

(j) Effective Date. Except as expressly set forth otherwise in subsections (c)(6)(A)6. and (e) of this regulation, this regulation is effective as of January 1, 1994.

History: Adopted February 9, 1995, effective August 18, 1995.

Amended November 7, 1997, effective December 7, 1997. Added new subdivision (c)(4) to incorporate provisions of Chapter 954, Statutes of 1996 and renumbered the following subdivisions. Subdivision (I)(1) was amended to add reference to Regulation 1525.3 and Appendix A & B were updated for clarity.

Amended December 8, 1998, effective April 3, 1999. Subdivision (f): phrase "Except ... (f)(3)," added to first sentence. Subdivision (f)(3)(B): phrase "does not" added and phrase "and ... purchase" deleted; last sentence added. New subdivision (f)(3)(C) added.

SECTION 6377 MANUFACTURER'S EXEMPTION CERTIFICATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

PLEASE NOTE

This is a partial exemption from sales and use tax at the rate of 5% effective January 1, 1995. You are not relieved from your obligations for the local and district taxes on this transaction. The exemption is specific to this transaction only and may not be construed to exempt other transactions. Generally, the partial exemption will not be allowed unless this certificate is issued within 60 days after the date of purchase and the retailer claims the exemption on a timely filed return. Void after expiration date.

Certificate No:

Expires:

I hereby certify that the tangible personal property described below and purchased or leased from: (enter seller's/lessor's name and address)

SELLER'S NAME

SELLER'S ADDRESS (Street, City, State, Zip Code)

and will be used by me primarily (please check one)

1. for manufacturing, processing, refining, fabricating, or recycling, or
2. for research and development activities as described in Internal Revenue Code Section 174, or
3. to maintain, repair, measure, or test any property being used for (1) or (2) above, at my facility located at (enter facility's address):

(Street, City, State, Zip Code)

CERTIFICATE NOT VALID FOR PURCHASES WITH A UNIT VALUE OF \$250.00 OR LESS

SALES INVOICE NUMBER	SALES INVOICE DATE	DESCRIPTION OF QUALIFIED PROPERTY PURCHASED OR LEASED*	SALES PRICE/ RENTALS PAYABLE

I understand that if such property is, within one year from the date of purchase or lease, removed from California or converted for use or otherwise used in a manner not qualifying for the exemption that I am required by the Sales and Use Tax Law to report and pay the state tax measured by the sales price/rentals payable of the property to/by me. *Attach a copy of the lease agreement.

PRINT NAME	TITLE
SIGNATURE	DATE
	PERMIT NUMBER

NOT VALID UNLESS COMPLETED BY THE CALIFORNIA STATE BOARD OF EQUALIZATION

The following business has been registered as a "qualified person" who has certified that this purchase/lease of tangible personal property will be used in a manner entitling them to the exemption provided in Section 6377 of the Revenue and Taxation Code.

BUSINESS NAME	SIC CODE	
BUSINESS ADDRESS (Street, City, State, Zip Code)		PERMIT NUMBER

AUTHORIZED BY (Must Have Two Signatures)

REVIEWED BY	DATE
APPROVED BY	DATE

SECTION 6377 MANUFACTURER'S USE TAX DECLARATION

STATE OF CALIFORNIA
BOARD OF EQUALIZATION**PLEASE NOTE**

This exemption being declared applies only to the state use tax which is at the rate of 5% effective January 1, 1995 and is specific to this transaction only and may not be construed to exempt other transactions. As the purchaser, you remain liable for the applicable local and district taxes. To claim the exemption, this declaration must accompany a timely filed sales and use tax.

Certificate No:

Expires:

I hereby certify that the tangible personal property described below that is subject to use tax was purchased or is being leased from: (enter seller's/lessor's name and address)

SELLER'S NAME

SELLER'S ADDRESS (Street, City, State, Zip Code)

and will be used by me primarily (please check one)

1. for manufacturing, processing, refining, fabricating, or recycling, or
2. for research and development activities as described in Internal Revenue Code Section 174, or
3. to maintain, repair, measure, or test any property being used for (1) or (2) above, at my facility located

at (enter facility's address):
(Street, City, State, Zip Code)

CERTIFICATE NOT VALID FOR PURCHASES WITH A UNIT VALUE OF \$250.00 OR LESS.

SALES INVOICE NUMBER	SALES INVOICE DATE	DESCRIPTION OF PROPERTY PURCHASED OR LEASED*	SALES PRICE/ RENTALS PAYABLE

I understand that if such property is, within one year from the date of purchase or lease, removed from California or converted for use or otherwise used in a manner not qualifying for the exemption that I am required by the Sales and Use Tax Law to report and pay the state tax measured by the sales price/rentals payable of the property to/by me. *Attach a copy of the lease agreement.

PRINT NAME	TITLE
SIGNATURE	DATE
	PERMIT NUMBER

NOT VALID UNLESS COMPLETED BY THE CALIFORNIA STATE BOARD OF EQUALIZATION

The following business has been registered as a "qualified person" who has certified that this purchase/lease of tangible personal property will be used in a manner entitling them to the exemption provided in Section 6377 of the Revenue and Taxation Code.

BUSINESS NAME	SIC CODE	
BUSINESS ADDRESS (Street, City, State, Zip Code)		PERMIT NUMBER

AUTHORIZED BY (Must Have Two Signatures):

REVIEWED BY	DATE
APPROVED BY	DATE

THIS FORM MAY BE REPRODUCED

Appendix B

California Regulation, Reg. 23649-1. The Manufacturers' Investment Credit.--

(a) *In General.* The Manufacturers' Investment Credit (MIC) is allowed to any qualified taxpayer in an amount equal to six percent (6%) of any qualified costs paid or incurred on or after January 1, 1994, for qualified property that is placed in service in this state. A qualified taxpayer who leases qualified property for use in a qualified activity of the qualified taxpayer may also claim the MIC. Qualified property may be either new or used and must be placed in service in this state and used by a qualified taxpayer in a qualified activity for more than one year to avoid recapture of the MIC. The basis of any qualified property for which the MIC is claimed is not required to be reduced by the amount of any MIC claimed.

(b) *MIC for Qualified Costs Paid or Incurred in 1994 Must Be Claimed On Qualified Taxpayer's Return for First Income Year Beginning on or After January 1, 1995.* In the case of any qualified costs paid or incurred on or after January 1, 1994, and prior to the first income year of the qualified taxpayer beginning on or after January 1, 1995, the MIC shall be treated as having been allowed as of the date the qualified property is placed in service in this state but shall not be claimed by the qualified taxpayer until the qualified taxpayer files its California tax return for its first income year beginning on or after January 1, 1995. No MIC shall be claimed on any return filed for any income year commencing prior to the qualified taxpayer's first income year beginning on or after January 1, 1995. Fiscal year taxpayers who paid or incurred qualified costs on or after January 1, 1994, and during the qualified taxpayer's income year beginning in 1993, shall treat any such income year 1993 qualified costs as 1994 qualified costs to be claimed on the qualified taxpayer's 1995 income year return.

(c) *Cross References.* Regulation 23649-2 contains definitions applicable to Regulations 23649-1 through 23649-11, inclusive, Regulation 23649-3 contains rules relating to qualified taxpayers, Regulation 23649-4 contains rules relating to qualified costs, Regulation 23649-5 contains rules relating to qualified property, Regulation 23649-6 contains rules applicable to leases of qualified property by qualified taxpayers, Regulation 23649-7 is reserved, Regulation 23649-8 contains recapture rules, Regulation 23649-9 contains rules relating to carryforwards, Regulation 23649-10 contains general recordkeeping requirements, and Regulation 23649-11 contains other miscellaneous provisions. For rules relating to the MIC allowed to taxpayers under the Personal Income Tax Law, see Revenue and Taxation Code Section 17053.49 and the regulations thereunder.

(d) *General References.* For purposes of Regulations 23649-1 through 23649-11, inclusive, the following general references shall apply:

(1) All citations to the Revenue and Taxation Code are to the California Revenue and Taxation Code.

(2) All citations to the Internal Revenue Code are to the Internal Revenue Code of 1986.

(3) The credits provided for in Revenue and Taxation Code Sections 17053.49 and 23649 shall be collectively referred to as the "Manufacturers' Investment Credit" or the "MIC."

(4) Any reference to a taxpayer's income year shall mean the income year as defined in Revenue and Taxation Code Section 23042.

(5) Any reference to sales or use tax shall mean California sales or use tax imposed under Part 1 (commencing with Section 6001) of Division 2 of the Revenue and Taxation Code. Any discussion of California sales and use tax law in Regulations 23649-1 through 23649-11, inclusive, is based upon such law as in effect on the date these regulations become effective, and is generally intended to restate the requirements set forth in Revenue and Taxation Code Section 23649 and to be illustrative of, but have no effect on, the California sales and use tax law and the regulations thereunder. All examples which contain references to an amount of California sales or use tax shall be at an assumed hypothetical sales or use tax rate of eight percent (8%).

(6) Any reference to "Division D of the SIC Manual" shall mean that portion of the SIC Manual which includes Codes 2011 through 3999, inclusive.

Note:

Authority cited: Section 19503, Revenue and Taxation Code.

Reference: Section 23649, Revenue and Taxation Code.

(Adopted May 31, 1996; amended September 13, 1997.)

California Regulation, Reg. 23649-3. **Qualified Taxpayer.--**

(a) *In General.* For purposes of Regulations 23649-1 through 23649-11, inclusive, a qualified taxpayer is any taxpayer that is engaged in an activity that is described in Division D of the SIC Manual. The determination of whether a taxpayer is engaged in an activity that is described in Division D of the SIC Manual shall be made under the rules and methods described in the SIC Manual, 1987 edition, herein incorporated by reference, and the rules in this regulation on the basis of all of the facts and circumstances. Thus, for example, a taxpayer is a qualified taxpayer where such taxpayer is engaged in multiple business activities, one or more of which constitutes an activity that is described in Division D of the SIC Manual. For purposes of the MIC, a SIC Code assignment to a given taxpayer's activity made by any federal, state (other than the Franchise Tax Board), regional, or local government agency shall not be controlling.

(b) *Business Activities Treated as an Establishment.* The determination of whether a taxpayer is engaged in an activity that is described in Division D of the SIC Manual shall be made by reference to the classification of business activity rules contained in the SIC Manual. If a taxpayer is engaged in one or more lines of business that is treated as an establishment under the SIC Manual, and that establishment is properly classified in Division D of the SIC Manual, then the taxpayer is a qualified taxpayer. In contrast, if a taxpayer is only engaged in business activities that are properly classified in any division or divisions of the SIC Manual other than Division D of the SIC Manual, then the taxpayer shall not be treated as a qualified taxpayer.

(1) *Establishment.* For purposes of this section, the term "establishment" shall mean an economic unit (as distinguished from subunits such as departments), generally at a single physical location, where business is conducted or where services or manufacturing or other industrial operations are performed. For example, a factory, mill, store, hotel, movie theater, mine, farm, ranch, bank, railroad depot, airline terminal, sales office, warehouse, or central administrative office would each be treated as an establishment. There are two types of establishments under the SIC Manual, auxiliary establishments and operating establishments.

A. Activities Conducted at Different Physical Locations. Business activities conducted at different physical locations shall generally be treated as separate establishments. Thus, for example, if a taxpayer manufactures clay tiles in Los Angeles and operates a retail tile store in Tarzana, each of these activities would be generally treated as a separate establishment.

B. Activities Conducted at a Single Physical Location. Where distinct and separate business activities are performed at a single physical location (such as construction activities operated out of the same physical location as a lumber yard), each activity shall be treated as a separate establishment where all of the following are satisfied:

1. No single industry description in the SIC Manual includes such combined activities;
2. Separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data, such as financial statements, job costing, and profit center accounting; and

3. Employment in each such economic activity is significant (as defined in subsection (b)(4)).

Where all of the requirements in subsection (b)(1)B. of this regulation are not satisfied, then all of the activities conducted at that location shall be assigned a single SIC Code based upon the principal activity being conducted at that location. For example, where there are five distinct and separate business activities being conducted at a single physical location and none of those activities meet all of the requirements of subsection (b)(1)B. of this regulation, that location would properly be assigned a single SIC Code representing the principal business activity.

(2) *Auxiliary Establishments.* Auxiliary establishments are establishments that are principally engaged in performing management or support services for other establishments of the same taxpayer. Auxiliary establishments shall generally be assigned the same SIC Code as the principal activity of the operating establishment that they serve. However, establishments principally engaged in producing goods or providing services for other establishments of the same taxpayer, when such goods or services are covered by industries in Divisions A through D, inclusive, of the SIC Manual, shall be classified as operating establishments in such divisions of the SIC Manual on the basis of their principal activity. Examples of auxiliary establishments include, but are not limited to, the provision of management and other general administrative functions, such as accounting, data processing, legal services, research and development, testing, and warehousing.

A. Auxiliary Activities Conducted at a Different Physical Location than the Supported Establishment. Auxiliary activities conducted at a different physical location from the supported establishment or establishments shall be treated as a separate establishment, and shall be classified as either an auxiliary establishment or an operating establishment under the rules of this regulation. Thus, for example, if a taxpayer manufactures plastic foam products in San Jose and has a finished goods warehouse in Fremont from which it fills orders and ships the finished goods to its customers, each of these activities will be treated as a separate establishment.

EXAMPLE 1: C manufactures computers, an activity properly classified under SIC Code 3571, at its manufacturing plant in San Diego. C also conducts research and development activities at C's facility in Rancho Cordova for the purpose of enhancing the performance of existing C products and to develop new products to be manufactured by C. Assume that C's Rancho Cordova research facility is properly treated as a separate establishment under the rules in this regulation and principally performs research and development activities in support of C's manufacturing facility in San Diego. Under these facts, C's research facility in Rancho Cordova would be properly classified as an "auxiliary establishment" under the rules in this regulation. Moreover, since C's research facility is properly classified as an auxiliary establishment, it would be assigned the same SIC Code (SIC Code 3571) as C's manufacturing establishment in San Diego.

EXAMPLE 2: Assume the same facts as in EXAMPLE 1, except that C's manufacturing plant is located in Austin, Texas. Under these facts, the result is the same as in EXAMPLE 1 because the physical location of the auxiliary establishment is irrelevant to the determination of whether the activity being classified will be treated as an auxiliary establishment.

EXAMPLE 3: Assume the same facts as in EXAMPLE 1, except that C's research facility principally performs commercial research and development performed on a contract basis for parties other than C. Under these facts, while C's research facility would still be treated as an "establishment"

under the rules in this regulation, it would not be treated as an "auxiliary establishment" since C's research facility in Rancho Cordova does not "primarily" support C's manufacturing activity. Instead, C's research facility would be treated as a separate operating establishment, and would be assigned a separate SIC Code based on its primary activity (SIC Code 8731, Commercial Research and Development).

B. Auxiliary Activities Conducted at the Same Physical Location as the Supported Establishment.

Where auxiliary activities are performed at the same physical location where the supported establishment or establishments are located, the auxiliary activities shall be treated as a separate establishment, and shall be classified as either an auxiliary establishment or an operating establishment under the rules of this regulation, when each of the following is satisfied:

1. Separate reports are prepared on the number of employees, their wages and salaries, sales or receipts, property and equipment, and other types of financial data. such as financial statements, job costing, and profit center accounting;
2. The auxiliary unit serves other establishments of the same taxpayer; and
3. Employment is significant (as defined in subsection (b)(4)) for both the auxiliary and operating activity.

(3) *Operating Establishments.* Any establishment that is not treated as an auxiliary establishment shall be treated as an operating establishment and shall be assigned a SIC Code on the basis of its principal activity, which shall be determined by reference to its principal product or group of products produced or distributed, or services rendered. In the case of activities classified under Division D of the SIC Manual, the principal activity of the establishment shall be determined by reference to the value of production of each product being produced. For purposes of this section, the product or service contributing the largest proportion of the cost of goods manufactured, excluding overhead, shall be treated as the principal activity of the establishment. However, in cases where multiple manufacturing and non-manufacturing activities are conducted at an establishment and the taxpayer can demonstrate that value of production does not adequately represent the relative economic importance of each of the varied activities being conducted at the establishment, the taxpayer may instead use employment or payroll information in the same manner to determine the principal activity of the establishment.

EXAMPLE 1: D is solely engaged in the following two activities, both of which are conducted at the same physical location--the manufacturing of wood kitchen cabinets and the retail sale of packaged dairy products. D employs 1 individual to manufacture the wood cabinets and 10 individuals to run the retail store. Assume the retail sale of packaged dairy products is the principal activity being conducted at this location. D does not maintain separate books and records for each of the activities, but instead maintains a single set of books and records. Since D does not maintain separate books and records for the manufacturing operation under subsection (b)(1)(B)2., and since the employment in this activity is less than 25% of the total employment and thus not significant under subsection (b)(1)(B)., the manufacturing activity does not constitute a separate establishment from the retail operation. Moreover, under the rules in this section, D's principal activity at the establishment would be classified under SIC Code 5451 (Dairy Products Stores). Therefore, D is not engaged in an activity described in Division D of the SIC Manual and is thus not a qualified

taxpayer.

EXAMPLE 2: Assume the same facts as in EXAMPLE 1, except that D employs 4 individuals in its wood cabinet manufacturing activity, but still does not maintain separate books and records for the wood cabinet manufacturing activity. Because the number of individuals employed in both the manufacturing operation and the retail operation is more than 25 percent of the total number of individuals D employs, employment in each of the activities would be considered significant. However, because D does not maintain separate books and records for each activity, D is treated as having only one establishment. Since the retail operation (SIC Code 5451--Dairy Products Stores) is the principal activity of D's single establishment, D is not engaged in an activity described in Division D of the SIC Manual, and is thus not a qualified taxpayer.

EXAMPLE 3: Assume the same facts as in EXAMPLE 2, except that D maintains separate books and records for the manufacturing activity. Since D is maintaining separate books and records, and the number of individuals employed in both the manufacturing operation and the retail operation is more than 25 percent of the total number of individuals D employs and thus treated as significant, both the manufacturing operation and the retail operation constitute separate establishments. As a result, D is engaged in an activity described in Division D of the SIC Manual, the manufacturing of wood kitchen cabinets (SIC Code 2434), and is a qualified taxpayer.

(4) *Determining Whether Employment is Significant.* For purposes of this section, the determination of whether employment is significant shall be based upon all of the facts and circumstances. However, employment in an economic activity shall be deemed "significant" whenever more than 25 percent of the taxpayer's total number of employees at a single physical location, or more than 25 percent of the taxpayer's total dollar value of payroll at a single physical location, is attributable to the business activity being tested for separate establishment status.

(5) *Activities Properly Assigned a SIC Code in a Non-Qualified Activity.* In the case of certain manufacturing-type activities that are conducted at establishments principally engaged in activities that are properly classified under divisions other than Division D of the SIC Manual, such activities shall not be treated as an activity described in Division D of the SIC Manual. Examples of these types of activities include, but are not limited to, the following:

- A. processing on farms if the raw materials are grown on the farm and the manufacturing activities are on a small scale without the extensive use of paid labor;
- B. threshing;
- C. cotton ginning;
- D. the dressing and beneficiating of ores;
- E. the breaking, washing, and grading of coal;
- F. the crushing and breaking of stone;
- G. the crashing, grinding, or other preparation of sand, gravel, and nonmetallic chemical and fertilizer minerals other than barite;

- H. fabricating operations performed at the site of construction by contractors;
- I. cutting and selling purchased carcasses;
- J. preparing feed at grain elevators and farm supply stores;
- K. stemming leaf tobacco at wholesale establishments;
- L. production of wiping rags;
- M. the breaking of bulk and redistribution in smaller lots, including packaging, repackaging, or bottling products, such as liquors or chemicals;
- N. establishments principally engaged in selling, to the general public, products produced on the same premises from which they are sold, such as bakeries, candy stores, ice cream parlors, and custom tailors;
- O. tire retreading and rebuilding;
- P. sign painting and lettering shops;
- Q. computer software production; and
- R. the production of motion picture films (including video tapes).

EXAMPLE 1: B is engaged in the retail sale of bakery products and the manufacturing of fresh bread products primarily for direct sale by B on B's premises to retail consumers. Both activities are conducted at a single physical location in Auburn. while B's manufacturing activity appears to be "described in" SIC Code 2051 (Bread and Other Bakery Products), if B's principal activity is the retail sale of these bakery products, then B will not be treated as engaged in an activity described in Division D of the SIC Manual since B is properly treated as being principally engaged in the retail sale of bakery products under SIC Code 5461 (Retail Bakeries). As a result, assuming that the baking operation is not properly treated as a separate establishment under the rules of this section, the baking operation would be properly classified as being part of the retail bakery operation.

EXAMPLE 2: Assume the same facts as in EXAMPLE 1, except that instead of selling most of its bakery products through its retail store, B sells 80 percent of its bakery products to the wholesale bakery trade. Assuming that B's manufacturing operation would otherwise be properly treated as a separate establishment from its retail store, then B would be treated as engaged in an activity that is properly classified under SIC Code 2051 (Bread and Other Bakery Products).

Note:

Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 23649, Revenue and Taxation Code.

(Adopted May 31, 1996.)